DEFENSIVE REAL ESTATE INVESTING

10 Principles for Succeeding Whether Your Market is Up or Down

William Bronchick, Esq.

Author of the bestselling *Flipping Properties*

with Gary Licata

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Preface

Instead of the Latest "Secret Formula," Learn Proven Steps to Success

The recent "real estate boom" has led to an equally great boom in the number of books published on the subject of how to make money in the real estate market. Everywhere you turn—whether it's print, television, or the Internet—people are talking about real estate. Is it going up or down? Do you get in now, later, or is it too late? There are many resources: some good, some bad, some original, and some just a rehash of old ideas. Occasionally, though, an author writes a special book that really sets him or her apart from the pack. That such writer is William "Bill" Bronchick.

Bill Bronchick is an accomplished author, speaker, commentator, and real estate investor. This book, *Defensive Real Estate Investing*, is a culmination of his years of practical experience and the experiences of other investors we know. For those of us who view real estate investing as a profession, Bill has produced a book that anyone can use, whether you're a novice or seasoned professional.

Defensive Real Estate Investing is an in-depth look at the challenges of succeeding in both the short term and long term as a real estate investor. Novice investors are often looking for a "magic bullet"—an idealistic, hopeful way to make a quick buck. These impetuous investors soon realize that their approaches to investing don't work consistently and they're off in search of the next "secret formula" that will make it all work.

At some point, novice investors (and even some experienced investors) come to the frustrating conclusion that real estate investing is harder than they thought. If this is the case, why do so many people believe you can get rich quickly by investing in real estate? Given this conundrum, is it possible that success in real estate investing is limited to the lucky or privileged few?

Bill says, "Success in real estate is for just about everyone." It doesn't matter whether you have an hourly job in a fast-food restaurant or you're the CEO of a large corporation. You must, however, follow certain steps to be successful. If you take shortcuts, you run the risk of failure. Instead of offering a magic bullet or secret formula, *Defensive Real Estate Investing* provides you with concrete steps to success.

Successful Investors Are Made, Not Born

To be a successful investor, you must acquire the correct real estate investor mindset, learn sound money management skills, and most important, develop a "can do" attitude with an appropriate plan of action.

Bill has developed several brilliant acronyms that make it easy to learn and remember these steps to success, like the "Buy the WOB in the MOB near the Blob" and the CLEAR method of analyzing a deal to determine if it is a great deal. (You'll learn about these concepts later in this book.)

Remember, to succeed, you must first learn to think like a successful real estate investor. After you read this book, you'll have gained the real estate investor's mindset and you will have a set of guidelines to use and review. Success in real estate investing looks easy and it can be—but only for those who know how.

This book is both for serious beginners who are studying real estate investing and for experienced investors who need to go back to the basics to polish their techniques and improve their profits.

I've known Bill Bronchick for more than ten years. Together, we offer more than 40 years of combined real estate experience. It's been a privilege collaborating on this book. In fact, through him, I've relearned real estate investing techniques that have helped me become a more profitable investor.

My recommendation therefore is to enjoy *Defensive Real Estate Investing* to develop the proper real estate success mindset, learn sound money management skills, and develop your "can do" attitude and plan of action. I invite you to read, enjoy, and learn from our experiences.

—Gary R. Licata

Introduction

The Key to Success is Using Ten Principles of Defensive Investing

Countless people are attempting to become real estate moguls in today's market. All of them, in one way or another, strive to be successful. Gary Licata and I know from our past 40 years of combined experience that, unfortunately, the vast majority of these people will fail. Despite their best efforts, many of them won't be able quit their day job or, if they do, they may not be able to sustain a steady income stream by being a real estate investor. Many of them will go to from one seminar to another, read book after book, and eventually quit the business altogether out of frustration, failure, or impatience. You may know someone like this or you may be that someone. Is there an answer to this dilemma? Yes, and you'll find the answer in this book, *Defensive Real Estate Investing*.

Real estate markets go up and down, and every investor, whether novice or experienced, must learn the principles of successful investing to survive. While the title *Defensive Real Estate Investing* suggests that this book is intended for those investing in falling housing markets, the principles apply to every market. This book conveys ten universal principles that have stood—and will continue to stand—the test of time. Regardless of where the market is heading, ten principles of defensive investing will work for you every time, in any market.

The Ten Principles—Proven and Reliable

These ten principles are not magic bullets; they're tried and tested concepts that are proven and reliable. We use these methods in our own real estate investing careers. In addition, we've met thousands of investors who have succeeded and failed. We've elicited a common thread from their successes and failures for this book.

Take one of our clients, Sharon. A few years ago, she and her husband wanted to make a move out of their stressful business. Doing fairly well, they had managed to save a few hundred thousand dollars.

However, they were nearing retirement age and didn't have enough money in their retirement savings to retire comfortably.

Sharon enrolled in one of our coaching programs. She learned the successful principles of the real estate investing business, and in less than three years, has purchased 17 properties with a net worth of over one million dollars! Her success was typical of someone who has a sound investing strategy, not just because she had a few hundred thousand dollars to invest. Many people start out with a decent nest egg and lose it because they don't have a plan or squander it in low-yield investments that take too many years to accumulate the sufficient funds for a healthy retirement.

You may be thinking, "I don't have several hundred thousand dollars. How can I get started and be assured of similar success?" You simply don't need a lot of money to get started. In fact, most people we meet have less than $20,000 when they start their real estate investing careers. In fact, the more cash you start out with, the more you have to lose, and thus the more "defensive" you have to be in your approach.

"Defensive," among other things, means being thoughtful, conservative, and not-too-risky in your approach. It means knowing where you are in the real estate cycle, whether you are in an up or down market; you don't want to sell too early or buy too late. It also means knowing how to preserve your cash flow, analyze a deal from all angles, and run your investments like a business.

If you use the techniques outlined in this book you can be independently wealthy in fewer than ten years. Keep in mind that real estate investing isn't a "get-rich-quick" scheme. It takes time, diligence, persistence, and good planning. Above all, it takes using intelligent investing principles.

If you apply what you read in this book, you can be a successful real estate investor, no matter where you're starting. When we speak at one of our seminars, it gives us great pleasure to look at the faces in the crowd and wonder who will be the next success story. This book shares the message of intelligent investing. We hope it will have an impact that will set you in the right direction. We've written this book as a resource you can use daily. Please don't read it only once and put it away.

Each chapter in this book directs you towards one of the ten principles of defensive investing.

In Chapter 1, you learn what it takes to be a real estate investor: the virtue of patience. We provide real-life examples that guide you through the investing process and help you develop the necessary skills to be a successful real estate investor. Getting rich is a matter of degree. How rich do you want to be, where do you start, and how do you reach your goals? We help you answer these questions in Chapter 1.

Chapter 2 discusses in detail the real estate market, how to determine the market you're in, and how can you use that information to profit. Discussions include median versus average prices and what this means to you. In addition, you learn whether market timing is a good or bad idea.

Chapter 3 is the essence of the investing world—that is, learning how to determine the true value a house and sell it for a profit. We detail what it takes to rehab a property, identify which repairs add value, and determine which improvements and repairs to avoid because they won't increase your return on investment. You'll also learn which real factors determine value and how they can help you buy a house at the right price.

Chapter 4 is probably the most important chapter in this book. You'll discover how to make your profit when you *buy* (versus making a profit when you *sell*). If you don't understand what we mean, be sure to read every word of this book more than once!

Chapter 5 provides insight into where to invest. Do you invest in your own backyard or in another part of the country? Is location more important than price or vice versa? We provide specific examples of the types of projects that are worth taking on and show you how to analyze a deal. You'll also recognize the certain types of properties that are more profitable than others—and which properties you should avoid at all costs.

Chapter 6 discusses the critical topic of cash flow versus cash reserves. We detail sources of cash and formulas for analyzing cash flow. Moreover, if you aren't starting with much cash, we teach you how to generate a cash reserve.

Chapter 7 prepares you for exit strategies. The reality is that not all deals work the way you anticipate so it's important to have multiple plans of action and a backup plan.

Chapter 8 gives you details about legal and tax aspects of real estate. You'll learn simple techniques to keep the profit you earn.

Chapter 9 reveals common real estate investment scams and traps you must avoid, the common myth about "nothing down," getting cash back at closing, and other "get-rich-quick" schemes. You'll identify these schemes and determine how to protect yourself from unscrupulous investors. We also show you what to look for when researching an investment club.

In Chapter 10, we provide specific examples of how to treat real estate investing as a business. That includes how to set up your company and your office, set goals, bring in partners, hire employees, and take the steps necessary to be a professional real estate investor. You'll assess your strengths and weaknesses and bring together the important members of your real estate success team.

The Real Secret to Successful Investing

The secret is there's no secret. Nevertheless, we can offer a solid piece of advice based on our years of experience: *Take investing one step at a time*.

That means plan carefully, don't overdo it, and build up slowly so you don't get off track. If you were planning to run a marathon, you wouldn't just show up for the race, would you? Of course not; you'd prepare and take it one step at a time. You'd consult with experts, plan your training schedule, work on your stamina, eat well, cross train, stretch before and after each run, and build up to the big race.

Writing this book has been a labor of love based on our personal experiences, failures, and successes. We enjoyed collaborating on the ideas for this book. We want to share our experience with you to prevent you from making mistakes. Most of all, we want to help make the investing process easier and more profitable for you.

After we speak in public, we often ask each other, "Who's going to be the next successful investor from this group?" Will it be you? If you apply the ten principles of defensive investing, you'll change your mindset about real estate investing forever.

Remember, success is a *process*, not a place. We hope you enjoy the process and can benefit from our help to get you to the top—wherever that is for you.

—Bill Bronchick and Gary Licata

CHAPTER

1

Don't Try to Get Rich Quick

"The things that will destroy America are… the love of soft living, and the get-rich-quick theory of life."

—Theodore Roosevelt

As we discussed in the introduction, investors should be defensive in their approach to real estate investing, whether the market is up or down, good or bad.

To build wealth quickly, the assumption is that one must accept more risk. This assumption is generally correct, but lowering risk means more than just doing things more slowly; it means thinking things through before you take action. The ten principles in this book determine exactly how you can do that in your real estate business.

Getting Rich in Real Estate Isn't Easy or Instant

Generally speaking, people want something for nothing. This statement may sound cynical, but ask yourself these questions and answer honestly:

- Would you rather work more time or less?
- Would you rather have more income or less?

- If we can show you how to make more and work less, would you be interested in hearing how?

Doesn't the last question sound like a typical late-night infomercial? This is why advertisers are so good at exploiting human nature!

If getting rich in real estate were easy, everyone would be doing it. It's not easy. Many aspiring investors are lured into the world of real estate investing because they see other people doing it and want to taste a better life. Unfortunately, it isn't realistic to expect instant wealth without first investing considerable time and effort. While many people have gotten rich quickly in real estate in recent years, more often than not, it was pure luck. Most investors who succeed in real estate do so in the long term—through hard work and patience. Those who try to "crack the code" and shortcut the system are often disappointed.

Another common mistake impatient investors often make: They learn a few tricks and think success will instantly follow. Another common mistake is seeing the instant success of someone else and believing you'll have the same results. In reality, this rarely (if ever) happens. These people may have had a good plan, but face failure because they didn't give the required effort necessary to achieve the goal. It takes a lot of work to achieve long-term success in real estate, which is why so few accomplish it on a grand scale.

Many people start out in real estate investing with great fervor, only to become discouraged after a few months when they don't attain instant fortune. They discover they can't get rich quickly and easily so they move on to the next investing scheme.

Surprising as this may sound, real estate has a lot in common with weight loss. In real estate, as in the weight loss industry, everyone talks about it and many try it, but few experience real long-term success! Both industries offer thousands of "get rich quick" and "get slim quick" gimmicks, making billions of dollars in sales in the "getting people to try."

If you've tried to lose weight, you know it isn't easy. In fact, it's a serious challenge. Yet the basic concept is simple: eat less, exercise more. Even with this approach, most people give up after a few weeks because they don't have the discipline or the patience to work consistently at a well-defined plan.

Does this mean that all the weight loss plans you see on television are a scam? No, most of them will work if you follow their plan. Likewise, most of the techniques advertised on real estate investing infomercials do work if you work. Admittedly, like weight loss commercials, the results take longer for some people than for others. The problem is that too many people are impatient and either give up or, worse, engage in risky or speculative real estate deals that end up bankrupting them.

The bottom line is that if you set realistic expectations, apply our principles, have a good plan, and work hard, you'll succeed.

Start with Realistic Goals and Expectations

Thinking big is great, but we cringe when we hear someone say, "I want to make a million dollars in real estate in my first year." Everyone loves a dreamer, but there's a fine line between dreams and delusions! Someone who earns $50,000 a year and has no prior experience in real estate probably wouldn't make that kind of money by next Christmas.

What kinds of expectations are realistic for a beginner? The best approach is to set short-term, intermediate, and long-term goals. Be sure your goals are realistic, specific, and attainable. For example, your goals may look like this:

- Fifteen-year goal: Retire with $10,000 in passive income per month, inflation-adjusted. This may require between $3 and $4 million in free-and-clear rental real estate.
- Five-year goal: Acquire between $3 and $4 million in real estate in steadily appreciating areas. Buy, fix, and flip five properties per year at an average profit of $20,000 to replace current income.
- One-year goal: Buy, fix, and flip two properties and acquire three rental properties to keep.
- Six-month goal: Buy one rental property and one fixer-upper.

Be as specific as possible and take time to do the math. For example, if your goal is to retire within 15 years, how much income will you need to attain that goal? If you need $10,000 per month, will that require owning and collecting rent on five houses? Ten houses? Will you be managing that property? If you pay a manager, how will that affect your bottom line? If you need $10,000 in today's money, what will that amount be worth adjusted for inflation? The more diligently you put the pen to paper—or the fingers to the keyboard—the better prepared you'll be.

To avoid setting yourself up for certain disappointment and possible financial disaster, you must forget the dream of becoming an overnight millionaire. Instead, focus on the slow-and-steady route, aiming to accumulate wealth one small step at a time, one deal at a time. (We'll discuss setting goals in more detail in Chapter 10.)

Most important, be *defensive* in your approach. Think things through. Be conservative and cautious while always considering the risks. Real estate generally goes up and down in natural market cycles about every seven to ten years from top to bottom to top (or from bottom to top to bottom, whichever way you view it). Could property values decline after you buy them instead of increase? Could you end up at the bottom of a cycle when you plan to retire, and how will this affect your decisions? Could inflation be more than you expect? Could your kids' college cost more than you anticipated?

When you develop your goals, spend plenty of time. Be sure to look at the positive and also anything that could negatively impact your goals. Imagine that you're preparing this plan for your boss—what would he or she think about it? What aspects would you need to clarify and present in more detail if you had to "sell" it to someone else?

A True Story: Focus on Quality, Not Quantity

Steve bought 140 investment properties in his first three years of investing. Each house he purchased had less than 10 percent in equity. He hoped that appreciating values would be his payoff. Unfortunately, the real estate market in his city leveled off and he ended up with multiple vacancies, negative cash flow, and financial distress. Steve would have been better buying one-third as many properties with more equity while focusing on quality deals rather than quantity.

Developing Skills Takes Time

When you invest in real estate, risk is directly proportional to education. Compare this to the stock market where even the most educated professionals still can't invest and achieve great returns with any degree of certainty.

On the other hand, real estate has a higher learning curve than the stock market, which means you must be willing to invest more time and resources to get results. Real estate is more like running a business than managing an investment, so it takes more time to learn. If you're hoping for success in real estate (or any challenging field), you must be prepared to invest time to develop the necessary skills and expertise. Too many aspiring investors assume they can jump into the fray and learn as they go. Certainly many people do this, but the stakes are high; there's plenty of money to be made in real estate, but there's plenty to be lost! More often than not, foolish investors jump into investing without knowing the rules and end up paying an expensive lesson.

At any given time, in virtually every major city across the nation, numerous real estate seminars are offered to guide you through the learning curve. Seminars run the gamut from affordable to expensive and from useless to very helpful (and everywhere in between). We recommend that you attend a few reasonably priced seminars; you'll likely learn at least a few helpful tips. In addition, this gives you the opportunity to meet other investors in your area.

How do you know if a real estate seminar is worthwhile? Here are a few facts to consider when determining whether to invest in a seminar.

- **Price**—Be cautious of seminars at either extreme of the price spectrum. If the seminar is free, it's usually because the promoter plans to make a profit by selling his products to the attendees. If you attend free seminars, be prepared for a sales pitch for books, CDs, coaching, or other seminars. By contrast, expensive seminars sometimes leave investors feeling as if they didn't receive sufficient material to justify the high cost.

- **Class size**—Free or low-priced seminars generally require large audiences to make the event cost-effective for the promoters. This means it'll be difficult to ask questions or receive individual instruction.

- **The expert's teaching ability**—Some experts are knowledgeable in their field, but they simply don't have the teaching skills necessary to convey information in an interesting and easy-to-understand manner. Unfortunately, it's difficult to judge a speaker's teaching ability beforehand unless you can get feedback from others who have previously attended one of the speaker's events.
- **Refund policy**—All legitimate seminars should offer some type of refund policy. Always ask about the refund policy before registering for any events.
- **Your commitment level**—Until you're completely certain that you wish to pursue the real estate business seriously, avoid spending an excessive amount of money on seminars or coaching programs. It's wiser to attend a few low-priced seminars first while you're deciding whether you're really committed to this field.

Many investors go to one extreme or the other—they jump into real estate investing without an education or they spend tens of thousands of dollars on education and don't ever buy a property! Neither outcome is desirable, but certainly there needs to be a balance. Our advice: Learn a little, take action, then learn more and apply it. Education is a lifelong process. *Chances are, the more you learn, the more you'll earn.*

Success Requires Education plus Action

Some people are critical of the real estate seminar business because it attracts so many people to real estate investing, yet few people make the grade in real estate, even with the right education. Success takes more than education; it takes massive action in the direction of your goals. If you don't plan to apply new information, then getting an education and spending money on seminars and books is a waste. Nevertheless, given the two extremes, you can lose a lot more money by making a mistake than by attending seminars and doing nothing. So invest in your education, or you'll learn an expensive lesson with the first mistake you make. We call that going to a "real-life seminar."

Mentoring and Coaching Programs

Ideally, finding an experienced mentor who can guide you through the process of real estate investing is infinitely important. However, few people offer mentoring for free and, even so, such a person may be a poor teacher or mentor. Currently popular are coaching and mentoring programs from "gurus" who charge as much as $25,000 or more. If you're willing to pay a high price for this type of program, ask the seminar leaders the following questions before you sign up:

1. Who will be teaching me—you (the guru) or someone else?
2. How quickly will you respond to questions?
3. Are you currently active in real estate investing?
4. How many students are in the program? Will you give me their names and contact information?

The Internet is a great place to find reviews from people who've participated in coaching programs, but keep in mind that most of the opinions you get from people about anything on the Internet are negative. It's human nature for people who are dissatisfied to voice their opinions, particularly those who don't succeed and want to find someone else to blame for their failures.

In today's information age, there's no excuse for making a mistake that someone else has made and can teach you to avoid.

The more you learn, the less daunting real estate investing will become for you. Being defensive means taking time to anticipate potential pitfalls and, most important, being aware many pitfalls exist that you didn't even think of. The only thing more dangerous than ignorance is the ignorance of what you are ignorant about! (Think about that last sentence for a moment.)

Key Points to Remember

The most important concepts addressed in this chapter are:

- There is no magic bullet or secret to overnight real estate success.
- You must have patience to accumulate wealth.
- Take the time to plot an action plan—and stick to it.
- Get an education before attempting your first deal.
- Learning isn't enough; you must take action to achieve results.

CHAPTER

2

You Can Profit in Any Market, but You Must Know Your Market

"Give me six hours to chop down a tree and I'll spend the first four sharpening the axe."

—Abraham Lincoln

The most common myth in real estate: You can only make profits when the real estate market is rising. While it's true that *more* people make money in rising markets than falling markets, the reason is often luck, not good market timing. Armed with the right knowledge, you can profit in any real estate market.

First, however, you need to apply the second principle—*know your market*—so you can plan your investing strategy to fit that market. The defensive investor cannot operate in the dark with improper assumptions about where the market has been and is going. Different strategies apply to different market conditions, so it's critical to first assess the investor's target market thoroughly.

What Determines the Market?

Most people think of the real estate market as something that's measured like the stock market—bearish or bullish. In real estate, the common expressions for a bull market are "up," "strong," "good," "hot," and "seller's." A bearish market is described as "soft," "bad," "down," or "buyer's." On a daily basis, you'll hear the media use these expressions to describe the real estate market based on facts and figures, most of which are confusing to the average investor. Let's discuss each of the categories for the numbers you may be hearing and see how they affect the market and, more importantly, your investing strategies.

Market Categories

New home sales. Sales of new-construction homes is an indicator used by many market economists to measure the strength or weakness of the housing market. This data comes from homebuilders in the form of scheduled permits for new home builds and orders for new homes from consumers. This data is somewhat relevant to your investing plan because it can show how strong the demand is for new homes. However, keep in mind that in some places—such as inner cities where there is no available land—developers aren't building new homes in mass quantities. Likewise, in suburban areas where land is plentiful, there is endless room and an oversupply results.

Note that most of the homebuilders in the United States are large companies that operate in many different markets. These companies work on large volumes and may continue building houses in markets where they are breaking even or possibly losing money, simply because they've committed to building permits and plans. Therefore, while large builders are still making new homes in a particular market, they're often looking at long-range plans, not short-term financial decisions. This can create a false sense of market strength, not to mention an oversupply problem that can affect the rest of the local housing market.

A good way to tell if a builder in your market is doing well is to look at its supply of housing. A typical supply for builders is about six months of homes, that is, if they stopped building, they'd run out of existing inventory in six months. Having more than six months on hand is a sign of oversupply. The reverse is also true. Plus, if builders are selling lots without homes on them, this generally means they own too much land, another sign of a soft market for new homes in that area.

Be sure to compare apples to apples. When you analyze home-building and sales data, it's important to compare single-family homes with single-family homes. Condominiums and multifamily homes have different buyers, so it's possible to have a strong demand for one and not the other. This is why data for single-family homes, condominiums, and multifamily homes is often broken down in sources that report on real estate.

Our Advice: Look for Investment Projects Near New Developments

One side effect of building new housing is having a place for new homeowners to shop. Massive new home developments are often built in places where there is no shopping, so inevitably a strong retail market will follow. We suggest that you look for opportunities to invest in projects that "feed" off new residential housing developments.

Home resales. The resale of existing homes is another indicator of your local real estate market, particularly in areas where there isn't a large supply of new homes. This data comes from the REALTORS® associations such as the National Association of REALTORS® (NAR). Note that the price of home resales is more important than simply the number of homes sold. Also, home resales may be stated as, "sales of homes down 15 percent." This simply means the number of homes sold has decreased, not the price. A decrease or increase of the number of homes sold is only part of the equation. Data for home resales can be found at **www.realtor.com**.

Mortgage applications. Applications for new mortgage loans show data that is ancillary to the sale of new and existing homes. Of course, some of this is refinancing, which is driven by the rising efficiency and falling cost of loan processing and in large part driven by low interest rates. Statistical data for mortgage loan applications can be found at the National Association of Mortgage Brokers' Web site at **www.namb.org**.

Rental vacancy rates. Rental vacancies are relevant to the values for multifamily housing, and they can be a good sign of what's happening in the single-family homebuying arena. When interest rates are low, homebuying goes up on the low-end of the price scale, simply because it's cheaper to make mortgage payments than rent payments. This trend leads to higher vacancy rates in an area and, thus, lower rents. Why? Because in this market, managers and owners lower their rents to make properties more attractive to the few renters that are available. Likewise, when interest rates and home prices rise, renting becomes a cheaper option. This causes a drop in the demand for single-family housing and an increase in the demand for rental units and homes. Daily interest rate data can be found at **www.bankrate.com**.

Cost of materials. The increase in the cost of certain building materials can affect housing prices. For example, a rise in the cost of timber can affect the cost of housing nationwide.

It's worth noting that often these statistics are based on nationwide facts and figures. The nationwide statistics aren't as important to you if you're only buying in your local market. (In most cases, this is your own backyard or a particular "emerging" market.) The stock market uses indexes to determine the market as a whole, but is this really important if you only own two stocks? Likewise, does it matter how many homes sold nationwide when you only buy homes in Cleveland? In short, you need to focus primarily on local trends rather than national trends. (The two exceptions to this rule are interest rates and income taxes, discussed next.)

Interest rates. Nationwide and even global factors such as the Federal Reserve rate, worldwide markets, and competing investments such as stocks and bonds control interest rates on mortgage loans. When interest rates fall, housing becomes cheaper across the nation because homeowners' monthly payments are lower. However, the flip side of the equation is that when interest rates rise (particularly for borrowers who are getting adjustable-rate loans), the mortgage default rate will increase, causing a boost in the number of properties available for sale as foreclosures. Foreclosures are generally sold cheaper than other houses, which can drive down prices. If lenders are dealing with too many defaulted loans, they may tighten their practices, making it harder for people to borrow money, particularly those with poor credit and low income as well as those who want very large mortgages (called "jumbo" loans in the business).

Income taxes. Federal income tax rates, particularly on investment properties, can have sweeping changes on the real estate market nationwide. A prime example was the Tax Reform Act of 1987, which changed depreciation rules on investment properties and was a major catalyst to the downfall of real estate in many parts of the country. A similar change to the tax laws in the future (e.g., a change in whether property owners can deduct interest payments) can significantly affect the profitability of real estate for investors. A drastic change could drive investors away from real estate, causing a drop in the number of buyers, thus a drop in demand, and a resulting drop in prices.

Analyzing Your Market

Use the MAD Method

There are many complicated ways to analyze the market conditions in your local area, enough to confuse and boggle the novice investor's mind. However, you can keep things simple by using our "MAD" method. This means paying attention to three important factors and noting whether they're going up or down:

- **M**—Median housing prices
- **A**—Active listings on the market
- **D**—Days on the market

By paying attention to these three simple factors, you'll get a good snapshot of the state of your local market.

Median housing prices. The median home price is the exact middle of the scale, meaning that half the houses sold for less and half sold for more. Compare this with the mean or average, which takes the total number of dollar sales and divides it by the number of homes sold.

What Does Median Price Mean?

Let's say you had seven properties in a neighborhood and they sold for the following amounts:

- $87,000
- $110,000
- $112,000
- $115,000
- $118, 000
- $120,000
- $122,000

The median price of these properties is $115,000. The mean or average price is $112,000, which is logically closer to splitting the difference between the high and low sales.

Generally, the median price is considered a more reliable indicator of the state of the market than the mean price. Why? Because if more homes on the extreme high end or low end of the spectrum sell (as in this example), it can throw off the whole equation and provide a misleading figure. Therefore, using the median price is a better yardstick to measure your local market.

If median house prices in your area are rising, this can be a good indicator that your market is on the way up. If prices are rising, you can ride the appreciation of the properties. In this kind of market, you won't have to buy houses as cheaply, depending on your exit strategy (discussed in Chapter 7). However, if they have been rising for several years and the rise in price is slowing, it can be a sign that your market is flattening or getting ready for a fall. That requires you to be more defensive in your buying—that is, you would buy properties at a lower price and assume no market appreciation (or possibly anticipate falling prices in the short term). Also, keep in mind that many areas are seasonal, so housing prices may be higher in the spring and summer than in winter (or vice versa in ski resort areas, for example).

Our Advice: Use Housing Tracker to Find Median Prices

Web sites such as Housing Tracker (**www.housingtracker.net**) can help you keep abreast of the latest median prices of homes in your market. You can also use this Web site to compare past prices and other markets.

It's important to keep in mind that even if a real estate market is reaching a peak in prices within a particular area, this doesn't necessarily mean it will collapse. The fact that real estate values in a specific city have climbed at twice the rate of inflation last year and only half the rate of inflation this year doesn't mean the bottom is falling out because markets inevitably rise and fall in price.

A temporary excess of demand over supply causes a rise in prices, but supply almost always catches up. When it does, prices level off; sometimes they drop for a period and then rise again, with the next peak being higher than the last peak due to inflation. However, just because a boom in housing prices exists, a bust doesn't necessarily follow. A likely scenario may be a "cooling off" where prices remain flat, appreciating just above average inflation.

Keep in mind that just because your city's average real estate values or home sales may have declined, it doesn't mean this was true for the entire city. Unfortunately, people see headlines like "Median Real Estate Prices Falling" and they panic. You need to look specifically in the price range and location of houses you're buying. For example, the mass overbuilding of new $750,000 homes in your market may not affect the older $200,000 homes that you're buying. On the other hand,

What Causes a Real Estate Bust?

The "bubble" theorists claim that if housing prices rise too rapidly, a bust or sudden drop is likely to follow. However, the bubble theory is full of hot air, according to a report published by the Federal Deposit Insurance Corporation (FDIC) in 2005. A 25-year study of nationwide housing prices shows that only 17 percent of local markets "busted" (experienced a 15 percent decline in five years) after a boom period (experienced a 30 percent increase in three years). The vast majority of "busted" markets could be explained by local economic conditions that resulted in mass unemployment or a mass population decrease in that city. In other words, once hysteria subsides, most real estate markets tend to flatten or fizzle after a boom, rather than crash (absent other contributing factors such as a recession in the local economy).

To invest defensively, keep an eye out for local or national events or issues that could potentially kill a market, such as:

- rising interest rates,
- drastic tax or zoning law changes,
- a major local employer leaving town or downsizing,
- a local industry (such as oil or high tech) that is substantially affected by world events, and
- environmental issues such as lack of water supply, pollution, or public health issues (e.g., "cancer clusters").

it's certainly possible that a particular development or sector within a market (such as high-priced condominiums) could fall in a market in which median prices are otherwise stable or rising. In short, know your market on multiple levels—national, local, and microlocal.

Housing prices alone may not be an accurate indicator of the local market. Sellers often give buyers concessions at closing rather than drop the price, which can skew the math. For example, a concession may include paying some of the buyer's loan fees or allowing a credit for items that are in need of repair. In the case of new homes, housing prices don't always reflect builder concessions, such as favorable financing or upgrades.

In addition, housing prices don't reflect the amount of money sellers spend to renovate the property before the sale. In a seller's market, homes will sell quickly regardless of their condition. In a buyer's market, sellers may spend as much as 10 percent of the price of the home doing renovations before placing it on the market. Thus, for example, if the price of a house rose 5 percent in the last year, it's really a net loss of 5 percent for that area. You need to look not only at numbers, but also at the houses for sale. Go to open houses and talk with real estate brokers in a particular area to get a reality check of what's really going on.

Active listings on the market. This is the second factor to track in our MAD method of determining the state of your local market. The changes in the number of properties available for sale provide a good sign of the state of the local market. The basic economics of supply and demand determine whether the local housing market is rising or falling. When demand exceeds supply, prices rise—and the real estate market is said to be rising. When supply exceeds demand, prices fall—and the real estate market is said to be falling.

Most residential properties for sale are listed on the Multiple Listing Service (MLS). The number of active listings on the MLS today compared to six or 12 months ago (adjusting for seasonal changes) can tell you if the market in your area is rising or falling. A good real estate broker can provide you with the numbers for listings by searching the local MLS.

In addition, you can check your local building department for the number of permits for new buildings to see if more development is coming. Being active in local politics can give you the inside track on upcoming projects that builders are involved in to get housing developments approved. Also, it never hurts to make friends with people who are in ancillary businesses such as the subcontractors who supply goods and services to home builders. They often can provide prospective and "inside" information that the statistics won't show.

Economic Factors Behind the Math

Instead of focusing on price and inventory trends, take time to study the local economic factors that cause trends. Weather, cost of living, taxes, and overall “livability” can all play a factor in driving population statistics, but jobs are generally the main factor. If the job market is good, it will drive people to move into a particular area. If it’s poor, people will move away.

If housing supply is limited, find out why. Is it because of unanticipated demand or because of geographic limitations, such as lack of land or zoning restrictions? In some parts of the country, water supply, highway infrastructure, or political factors limit growth.

Keep in mind also that nationwide migration of the existing population will play a big factor as baby boomers retire.

Boomers may move to retirement-friendly areas and many will purchase second homes and condominiums in resort communities. This increases demand without increasing population. In addition, immigration from Mexico and other countries may affect housing prices, especially in border states where people come to work and live. Finally, “wildcard” factors such as terrorism, hurricanes, earthquakes, and weather may drive people in and out of certain parts of the country.

Days on the market. This is the third factor to track in the MAD method. It will help you determine the state of your local market, after median housing prices and active listings on the market. This factor is the average number of days it takes to sell a house in the relevant price range. For example, a market in which a house sells for $250,000 in three weeks is quite different from a market in which the same house sells in six months (the latter is known as a soft market). In a soft market, sellers can drop prices, give concessions, or wait longer for their houses to sell. The vast majority of homes are owner-occupied, so there's generally not a negative impact to sellers who can't sell their houses because they can continue to live in them unless sellers are in dire need to move because of a foreclosure, job transfer, or other firm deadline they're likely to hold out for more time to get their prices. If sellers have enough equity in their homes, they can refinance their loans and take their homes off the market.

You can find the average days on market for a particular-priced home by asking a real estate broker to search through the MLS. Make sure you're comparing apples to apples—that is, the average days on the market for houses in the same area and in the same price range. If the broker has access to the right information on the MLS, you can compare renovated versus nonrenovated homes to get a more detailed analysis. The more information you have, the more accurate your assumptions about the market will be and the more solid your resulting investing plan will be.

Our Advice: Watch for This Listing Trick

Because an old listing can spell trouble for a seller who doesn't want to appear too motivated, real estate brokers often cancel listings, wait a few weeks, and then relist a property that hasn't sold. Make sure you take this possibility into account when you're analyzing days on the market data.

Work Your "Farm" Area

Real estate brokers generally have particular neighborhoods in which they work, rather than an entire city. Brokers refer to this as a "farm" area. You'd be wise to adapt a similar approach to your business. The goal is to become an expert on one specific farm area, roughly 3,000 to 5,000 homes. In some locations, this will be easy because the homes are divided into subdivisions or developments.

You'd be wise to learn the neighborhood inside and out and become familiar with every detail about it.

Values. Become familiar with the high and low range of the neighborhood. If all the homes are similar and were built in the same time period, this task should be quite easy. You should be able to rattle off value estimates almost instantly upon hearing a few pertinent details about a particular property in your farm area, such as the style and size of the home. In older neighborhoods (usually 50 years or older), a particular geographical area may have a wide variety of homes, making it difficult to determine values. Novice investors should avoid these areas until they have more experience.

Schools. Schools, particularly elementary and middle schools, are an important factor for people with families who are considering moving to an area. Get to know the local schools and determine which are the most desirable.

Zoning and homeowners' association restrictions. Learn the restrictions on building and remodeling as well any homeowners' association (HOA) rules or covenants for the neighborhood that may affect its salability. For example, there may be a covenant restricting how many unrelated people can live in a home within that neighborhood.

Local shopping and developments. A new road, highway, or commercial development nearby can affect property values in a positive or negative way. For example, a new shopping center or highway nearby may improve values or be so close as to create undesirable traffic and noise. Get to know what's in the works by following local news and attending local city council and HOA meetings or by visiting the local zoning and planning department.

Failed communities. Many new developments that rely on a golf course, ski resort, shopping mall, or other attractions for value can tank quickly if the attraction closes, is becoming run down, or isn't as great as it was predicted to be. Be especially careful of the risk if the attraction hasn't yet been completed, such as a new country club.

Our Advice:
Always Use Common Sense

While statistics, calculations, and economic factors are relevant, so is common sense. Look around. Observe what's really happening in your farm area right now. Talk to your local real estate brokers, investors, and lenders for a better picture of the local market. Don't focus solely on broad nationwide, statewide, or even citywide statistics. Be concerned with the median prices in the particular neighborhoods in which you buy houses; the average time on the market; the changes in sales prices, inventory, sales concessions, and days on market from last year to this year.

You need more than a snapshot of your farm area—you need thorough, up-to-date insight on the housing situation in your farm area.

Different Markets, Different Strategies

Once you learn how to analyze where your market is and the direction it's probably going, then you can plan your investment attack.

Certain strategies work well in a rising market, others work better in a flat or falling market. Many strategies will work in *any* market, as long as you know your market and adjust your investing accordingly. Here are some of your options.

Flipping works in every market. Frustrated investors often complain that specific real estate techniques such as flipping (buying low and selling quickly for a profit) won't work in their market. We call this the "not in my market" myth. The reality is this: Flipping works in any market, depending on how you do it. For investors who buy dilapidated properties, rehab them, and sell them quickly, the market appreciation or decline isn't relevant to profit because the holding period is typically only a few months. If your plan is to flip houses, you only need to know what the resale value is for that type of house in that neighborhood and approximately how long it will take to sell (days on market).

If you're in a hot market, you can sell properties faster or, if you keep them, you can ride inflation—that is, realize gains from inflation over the years. Flipping in a hot market means you won't find as many incredible bargain properties, but you'll be able to get top dollar on any resale. If you time it right, the property may appreciate in the few months you've owned it.

Our Advice: Keep in Touch with Sellers in Denial

Buyers and investors are often more receptive to noticing the signs of a weak market than sellers may be. Sellers have a tendency to stay in a state of denial for a while, refusing to believe the market is taking a turn for the worse. They'll convince themselves that any slowdown is a temporary fluke or won't affect an "irresistible" property like theirs. Such a seller will be reluctant to consider a low offer. In this case, it's best to move on to the next deal rather than wasting time trying to get a reluctant seller to "see the light." Nevertheless, keep this seller in the back of your mind and check back after a few weeks or months. By that time, the seller may have accepted the reality of the market and might be more agreeable to discussing your offer.

Market timing. Without a doubt, price inflation is the easiest way to make money in real estate because you don't need to struggle to find a super bargain; you only need to hold on to the property long enough to ride the market. Markets generally go up and down in price cycles, about every seven to ten years from bottom to top to bottom again, with the next top being higher than the last. There are two problems with using this approach:

1. Your local market may move inconsistently with your retirement plans—your retirement age may end up in the middle of a bad market trough and you won't be able to sell or rent your properties for what you anticipated.

2. You may be wrong about the top or bottom of the market. Be sure to apply the market factors we discuss in this chapter to any market in which you choose to invest.

While there is no crystal ball, educated investors can make some good investments in places other than their own backyards *if* they're armed with the right information. (You'll find a list of sources for this data in Appendix 1.) However, keep in mind that market timing by itself isn't enough. You must learn how to make an investment within a particular market that makes sense.

The following chapters provide more guidance and formulas to help you make prudent investment decisions—whether your market is rising or falling in the short term.

Long-term investing works in any market. If you buy and hold property for the long term (15 years or more), you're not likely to lose. Real estate values go up and down in cycles, but they generally go up in the long run, with few exceptions. (The same is generally true of the stock market in the long run, but there's one problem: You have no guarantee that a company in which you invest will be in business in 15 years!) Therefore, if you try to time the market in the short term and make a mistake, you may end up doing just fine if you hold on to your investments long enough. Historically, median real estate prices outperform inflation over the long haul. At the risk of beating a dead horse: Be a defensive investor. That means have a solid plan as well as a good backup plan with an exit strategy if the first plan doesn't work. (Chapter 7 discusses multiple exit strategies in more detail.)

The Great Debate: Flipping versus Holding

Some investors focus on flipping—that is, turning properties over quickly, rather than keeping them long term. In some cases, holding property generates more long-term wealth for you than flipping. Therefore, you may consider flipping some properties and holding others. On the other hand, you may consider using the flipping strategy awhile, and then begin holding properties later. The big question is, "When should you hold versus when should you flip?"

The advantages of flipping. The main advantage of flipping is that you get your cash out immediately rather than later. For many people, the certainty of getting a paycheck right away is highly appealing. Flipping takes the real estate market *per se* out of the equation. If you buy a property correctly, whether the market is rising or falling is almost irrelevant, except for how long it will take you to resell the property. (Of course, if you buy cheap in a soft market, you can afford to hold a property longer.)

Flipping is generally good for your cash flow, which is important in any business. If you purchase houses and acquire too much equity and not enough cash, you may get into a cash crunch if you don't have additional income. (We'll discuss the importance of cash flow more in Chapter 6.)

Don't forget that you can flip houses as a part-time or full-time business. You can do as much or as little as you want and you can also afford to take a break from your flipping business. In short, once you empty your inventory, you're not tied to your business; you can take long vacations or up and move to another city and start over.

The disadvantages of flipping. The main disadvantage of flipping is that it's "hands-on" income: Once you stop flipping, you stop making money. If you're young and like to work for a few months and then take a few months off, the flipping strategy can work for you. However, at some point, you'll realize that if you keep spending the profits, you won't accumulate wealth.

In addition, if you flip, you lose the benefit of market appreciation. While market timing is a risky venture, a good market timer can gain wealth quickly with little effort by buying properties at the right time in emerging markets (developments, cities, or parts of the country that are ripe for economic growth and new jobs, thus new home building). On the other hand, if you buy a property in the wrong place at the wrong time, particularly for the wrong price, you can end up with a property you can't get rid of quickly enough. You could also get in over your head in a rehab project and have to bail, risking the loss of thousands of dollars.

Finally, if you don't spend all your income on living expenses, what will you do with it? A diversified portfolio is a good idea—you could put some of this cash in bonds, money markets, or mutual funds—but you might earn a better return by leaving your profits in real estate rather than taking them out.

The advantages of holding. Property holders can generate true wealth over the long term. Historically, property values appreciate at a rate greater than the rate of inflation in the United States. If you buy in the right neighborhoods, your annual appreciation may reach double digits. You can use properties with equity as collateral. You can provide rental income for your retirement years, and you can pass property down to the next generation. Once your rental properties are owned "free and clear," you have passive income from rents paid that gives you an income even when you're not working.

The disadvantages of holding. The main disadvantage to holding on to property is that your assets aren't liquid. Unlike stocks or bonds, real estate isn't easily converted to cash. When selling real estate, you have to locate a buyer and then pay transaction-related costs.

If you must sell when the market is down, you won't get the best price. If you have tenants in your property under a lease, you can't simply kick them out without notice. You have to wait until the lease expires, pay the tenant to leave early, or hope to find a buyer who doesn't mind having someone living in the property. Moreover, of course, the future is always uncertain. While real estate may have appreciated in a particular area an average of 10 percent over the past 20 years, it doesn't mean it will do so in the future.

If you hold properties, you also risk running into negative cash flow. There may be times when your properties are vacant or need repairs. That's when you have to dip into your savings to feed the proverbial "alligator at your door."

What's Right for You?

The important question isn't whether flipping is better or worse than holding, but which strategy is right for you. To discover the answer for yourself, ask these questions:

- Do I need additional income now or in the future?

- Am I in a high-income tax bracket that would be adversely affected by more income now?
- Does my local real estate market present opportunities to acquire bargains, yet still command high rents that would cover my expenses if I need to hold on to the properties?
- Do I have other income or savings that I could tap into in case my rental properties become vacant or need major repairs?
- Do I have the time and patience to deal with tenants and landlord issues?
- Is the local real estate market rising or falling at this time?
- Does bringing in income now or later fit into my short-term and long-term financial goals?

Most investors start out flipping houses, and then gradually work into managing rental houses or becoming involved in larger, more complex real estate projects. Some people don't have the temperament to deal with tenants and the headaches that come with rental properties. Some look for side income by flipping. Others want to quit their jobs and make flipping houses their full-time business.

As you can see, many investors were once in your shoes making these decisions. Be sure to consider all options, including a mixture of flipping and holding properties. Reevaluate your financial goals on a regular basis and adjust your real estate strategies to support these goals. Moreover, of course, make sure your strategy is appropriate for your local market.

Being defensive may mean adjusting your strategies on a regular basis, as well as re-evaluating your goals to work within market conditions. Sometimes the market works for you and sometimes it may be in conflict, but smart investors know how to make any market work to their advantage.

Key Points to Remember

The most important concepts addressed in this chapter are:

- Focus on one limited farm area and learn everything you can about that market.
- If you use the right approach, any type of market can offer great opportunities.
- Use our MAD approach to determine market conditions.
- Market timing alone isn't likely to work—you need to apply the principles of successful investing to any market.
- Consider a mix of flipping and holding properties.
- Whatever strategy you choose, be sure it supports your long-term investing and financial goals.

CHAPTER

3

Learn How to Valuate a Property

"Country clubs and cemeteries are the biggest waste of prime real estate."

—Rodney Dangerfield, from the movie *Caddyshack*

How do you know if you have found a good deal? You can't determine whether you have a good deal unless you know what the property is currently worth. In the stock market, the current day's trading price will give you an idea and you can compare that to the earnings report of the company. In real estate, the current valuation isn't so cut and dry. The third principle of defensive investing is learning to valuate a property.

Most novice investors are either ignorant or downright delusional when it comes to property values. A defensive investor does extensive research, verifies all assumptions, and is extremely conservative when estimating property values.

The Art and Science of Valuating a Property

To valuate a property, some people look at appraisals, others look at the tax assessor's value, and others say that a house is worth what someone will pay for it. Further confusing the issue, we can look at the income the property generates or the insurance replacement value. In some cases, the land is worth more than the house itself and any improvements are ignored.

All these factors have importance when you valuate a property so we'll discuss how to apply each factor and in which circumstances. Keep in mind that valuation is more of an art than a science, but by using a few formulas and practicing them, you can learn to valuate any property correctly.

Warning! Don't Ask the Person Who Has a Stake in the Property

The worst way to find out a home's value is to ask someone who has an interest in the deal. For example, asking the listing real estate broker for advice on what the property is worth is like asking your barber, "How's my haircut?" In both cases, they'll tell you what they think you want to hear. A bad deal burns many novice investors because they trusted someone for advice and that person was biased by the potential profit of the deal.

Common Methods to Estimate Property Value

Generally speaking, a good appraiser can pinpoint a home's value within 1 to 2 percent. As an experienced investor, we recommend you shoot for the same accuracy rate.

Appraisers typically use the following three ways to estimate a property's value:

- Comparable sales approach
- Replacement cost approach
- Income approach

Comparable sales approach. This is the most common method to valuate single-family homes and condominiums. The comparable sales approach (also known as *using comps*) involves comparing a specific property to other similar properties in the area that have sold recently.

Ideally, all the properties you consider should be roughly the same size and style. They should have the same number of bedrooms, bathrooms, and other rooms, and it's important that they're in the same neighborhood. Comparable sales are considered a very good indicator of the market because the market is always changing. Comps reflect these changes (More details about using comps are explained later in this chapter.).

Replacement cost approach. Using this method of valuating a property, you add the value of the land, the age of the building, and the cost to reconstruct the building. It's important to go by today's costs, not original construction costs, because it would most likely be more expensive to construct the building at current prices. The goal is to figure out what it would cost today to replace the building if a fire, natural disaster, or other unexpected event destroyed it.

The cost replacement approach is not as accurate as comps because of the variations of land values. For example, a "shack" on the beach that can be replaced for a few hundred thousand does not take into account the value of the land.

Income approach. The income approach is particularly useful when you're valuating commercial property and multifamily rental property with more than four units. The valuation of income properties is based on its capitalization or cap rate, which is the value of property compared to the income it brings in. Cap rates are a measure often used on income properties to make comparisons to other income properties. When using this approach, you base your figures on the building's actual current revenue.

It's important not to be misled by a seller's representation that he's renting the property for less than market because he doesn't want tenant turnover. In addition, don't go by "full occupancy" estimates either—vacancies are a real factor determined by the market and the condition of the property. While using the income approach does make sense for income properties, it's generally not as accurate as the comparable sales approach for single-family units because owners, not tenants, occupy most single-family properties. Thus, the comparable sale for an owner-occupant is more accurate than a sale to an investor who will rent the property. For two-unit, three-unit, and four-unit properties, it's best to look at both comparables sales and income. For lending purposes, the comp standard is generally used for four units or less.

Comparable Sales Method

The comparable sales method is the most commonly used—and the most accurate method—to determine the value of single-family homes, condominiums, and small rental buildings (two to four units). Therefore, the rest of this chapter describes how you can implement this formula in your investing activities. Much of the legwork noted here is what a professional appraiser would do. (We've provided a sample appraisal report in Appendix 2.)

When doing comparables sales, make sure you compare actual sales, not listings. Remember, a listing price is an asking price. Novice investors often look at listing prices to determine what a house is worth, but this isn't as accurate as looking at properties that have sold within the last six to 12 months.

Listing prices *become* relevant, however, if they're substantially different from the sold prices because it may indicate a trend (for example, a rapidly appreciating or declining market). Furthermore, when you look at sold prices, compare them to the original asking prices. This will give you an idea of where the marketing is heading.

Real estate brokers are notorious for choosing the highest priced listings and sales, then using them as your comparables. Not all brokers who do this are dishonest, but brokers are trained to be optimistic. Appraisers are more conservative and realistic about the amount for which the home will sell. Still, it can be helpful to take a peek at newer listings as a market barometer; if the new listings are substantially lower than existing home sales, for example, this may indicate a falling market.

In addition, you can have high-tech help when it comes to determining a home's value. Start by researching information about sold properties on your local government Web sites for your target area. Many tax assessors' offices and county courthouses have searchable online data-bases where you can view the prices for properties within a specific area. They usually list some information about the properties, including square footage. Subscriber Web sites such as **www.dataquick.com** and **www.electronicappraiser.com** can give you detailed information, particularly in areas where online data is scarce.

Free Web sites such as **www.zillow.com** that offer property data are available, but the information is less detailed than for the paid Web sites. For example, the seller's name may be missing, which could be relevant if the seller was a bank (as in the case of a foreclosure sale). If that's the case, it can't be considered a comparable sale because this property was sold in distress.

Be careful using Web sites that offer a computer-generated valuation. These are automated valuation models (AVMs), which are statistical models of many comparable sales of reportedly similar comparables. Many times they're not similar, but they're generally accurate within 10 percent. Remember, we advised you to become an expert in your farm area. If you're becoming an expert in your area, 10 percent isn't good enough. AVMs are useful for preliminary research and for getting a rough idea of value, but they aren't nearly as accurate as using your own eyes, driving by properties, and applying experience and common sense to create your own comps.

The most useful computer database for getting information about comps is the local Multiple Listing Service. This database shows the number of days on market and includes notes that indicate whether the property was updated, whether the seller offered concessions, and so on. This additional data is generally not available through other sources and most MLS systems aren't accessible to the general public, so having a real estate broker help you will be crucial.

Be forewarned: Comps provided by a broker who is listing the property may not be the best indicator of value. Agents carefully select the comps, providing the ones that best suit their own purposes.

While many factors come into play when you're evaluating a residential property's value by comps, the three key factors are location, size of the home, and the number of bedrooms and bathrooms. Obviously, you'll need to look at many other aspects before you can pinpoint the exact value of a property, but these are the "big three." You should be able to look at comparable sales involving properties with the same three factors and get a good idea of the value of properties you may invest in.

Location, location. This factor is extremely important when you're comparing sold properties. A professional appraiser typically looks at houses in the same subdivision and so should you. In the case of a subdivision where the houses are all similar and built in the same time period, you only need to compare similar houses with similar styles to get an accurate valuation. If there's a wide mix of properties in the subdivision, you may need to go outside of it to get comparable sales, but be careful with "dividing lines." Geographic dividing lines such as different sides of the river, the park, or a main highway may put the property in another school district and may not give you accurate comps.

Look Within a One-Mile Radius

Appraisers and loan underwriters generally look at comparables sales within one mile of the subject property. However, in populated cities, one mile may be too far. In rural areas, one mile may be too close.

Within a subdivision, you'll find variations in lots that affect privacy, road noise, or sunlight. These lot variations won't affect the valuation unless an extreme difference exists. For example, if a row of houses backs up to a major road, this may drop the value of the house as much as 10 percent. If a row of houses backs up to power lines or a garbage dump, the discount may be even more substantial. On the other hand, a great view may affect the lot substantially—in a positive way, of course. A location on a golf course, lake, ocean, or simply having a spectacular view may push values up by 25 percent. Take note of the assessed land value versus the improvements, then note what the average lot premium or discount amounts to. You can check the lot premium in new home developments by asking the builder. In older areas, the home sales records of similar houses in the neighborhood will be reflected in the prices of houses sold that are the same model, but have different lots. Amateur investors often make the mistake of comparing houses that are across the street from each other, overlooking the fact that the lots have significant variations.

What Is Assessed Value?

County tax assessors value property for tax purposes. This is called the *assessed value*. This figure usually has some bearing on market value, but don't rely on its real market value. Instead, look at the assessed value as it compares to the selling prices on the comparable properties as a reference point.

In some parts of the country, *assessed* value is a formula based on real value so the amount is more reliable. In either event, only use the assessed value as a benchmark. For example, if the assessed value of homes in your farm area is generally 90 percent of market value and your subject property is listed for double the assessed value, something may be wrong!

Square footage. When determining a home's value be sure to evaluate the home's square footage. Note that appraisers typically look at homes that are within 20 percent more or less in square footage as comparables. Doing the same shouldn't be a problem for you and your farm area. Generally (especially within a subdivision), most homes fall within a fairly limited size range. Granted, nearly every neighborhood has one or two homeowners who try to outdo their neighbors by building a behemoth that towers over all the other homes—and a few tiny homes may dot the neighborhood—but the majority will fall in the middle of the spectrum, often at several size increments. Therefore, you should be able to develop a good gauge for the selling price of homes in those particular sizes.

Not all square footage is created equal

Most people think that if a house has 1,000 square feet and is worth $100,000, then the 1,100-square-foot house next door would be worth $110,000. Wrong; the extra 10 percent in square footage equals only a few percentage points in value. If these two houses offer the same location, style, and number of bedrooms and baths, the 10 percent additional square footage won't change the valuation much because there is a fixed cost on a house based on the value of the land, cost of construction, sewer, subdivision plans, and more. An extra few hundred feet of space involves very little cost—only wood, nails, carpet, and possibly some minor electrical and plumbing costs.

Below-ground space. While finished basements can add value, the amount of value is less than it is for above-ground living areas. In addition, this greatly varies depending on different regions of the country. In humid areas, below-ground living space isn't as valuable to homeowners as in dryer areas of the country. Thus, the American National Standards Institute (ANSI) uses above-ground construction as the national standard for comparing values.

Sometimes homeowners refinish basements (or add other space) without obtaining proper building permits from the county. Be sure to check public records to see if the finished square footage represented by the seller matches the county's file.

Bill's Advice: Know the Local Laws

A client rented an illegal basement apartment to a woman who had stopped paying rent. We filed for an eviction in court for nonpayment of rent, but the judge dismissed the case. He said my client wasn't legally permitted to collect rent in the first place! In some parts of the country, added or renovated space requires a certificate of occupancy from the local building department before you can close on the sale of the home. In other areas, this sort of thing is overlooked. In short, get to know what's customary in your area.

Bedrooms and baths. To determine a home's value using comps, also look at the quality and number of bedrooms and bathrooms. After studying the farm area awhile, you'll become familiar with the price levels for the most common bedroom and bathroom combinations:

- two bedrooms and one bathroom ("two-one"),
- two bedrooms and two bathrooms ("two-two"),
- three bedrooms and one bathroom ("three-one"), and
- three bedrooms and two bathrooms ("three-two").

When comparing bathrooms make sure you understand the different types of bathrooms and compare them correctly. A full bathroom includes a shower, bath, toilet, and sink. A three-quarter bath has a toilet and a sink plus a shower but no tub. A half bath has a toilet and sink but no tub or shower. A three-quarter and full bath have roughly the same value, particularly if another bathroom in the house has a tub. A half bath has less value unless there are enough other bathrooms in the house. In addition, a five-piece bath (separate shower and tub) generally doesn't add more value than a regular full bathroom with a combination shower and tub.

Other factors that affect the value of the home. There are other factors to consider that will affect the value of a home, but generally you'd give these less weight than the location, size, and number of bedrooms and bathrooms.

Some houses have one-car or two-car garages, some have carports, and others have neither. The garage factors in some value, depending on the rest of the neighborhood. For example, if the neighborhood comps all have two-car garages, this can affect value as much as 10 percent on the subject property if it only has a one-car garage or no garage. However, if the houses are all small and there's a mix of garage options, the garage won't be as big an issue. Likewise, a four-car garage in a three-car garage neighborhood probably won't count for much either.

One exception is with condominium developments. Parking spots or garages are generally sold with condominiums and can have substantial value, particularly in large cities where parking is limited to the street.

In most cases, a swimming pool won't affect the value of a property. In fact, in most regions of the country, a pool may actually diminish the value because it's considered a safety issue and may take up precious backyard space. In hot regions like Arizona or southern Florida, though, a small dipping pool is a nice feature. However, it still won't affect the value to a large degree.

A House Is Its Own Best "Comp"

An appraisal is a certification by a licensed professional that a house is worth a certain amount based on comparable sales. It is, however, an opinion of value based on one person's analysis and experience. The actual "market value" is the amount a buyer is willing to pay and for which a seller is willing to sell under normal circumstances.

Investors often misunderstand the phrase *market value*. Here's a good way to understand this: Imagine that a home has been on the market for several months. Typically, homes in this particular market sell within a few weeks; if the seller doesn't receive a single offer, then you have to assume the property is overpriced. Several factors may contribute to the problem, including the condition, location, and layout of the house. However, all of these factor into the asking price. In short, if the house is priced right for its location, condition, and features, it will sell within the same time frame as other houses in the neighborhood.

Many times the real estate broker takes a listing at a higher price than "market" with full knowledge that the home is listed too high. Sometimes brokers do this to win the listing over competing brokers by telling sellers what they want to hear. Like the barber who says, "It's a great haircut," they'll say, "I'll get you a higher price." Most often, having an asking price that is higher than market is the seller's fault (rather than the broker's) because the seller has unrealistic expectations about the property's value. However, you can't always blame sellers. They get their information from other brokers, the sales prices of other homes in the neighborhood, information and misinformation from neighbors, and the most recent appraisal. Therefore, your job as an investor is to sift through the information and determine the real value of the property.

In the real estate business, the subject property is often its own best "comp." This means that the final sales price agreed upon by the buyer and seller is generally the property's true market value. It doesn't matter what the real estate broker, appraiser, neighbor, or mortgage broker have said. *The actual selling price will often determine the property's value.*

A common trap for novice investors is the so-called "bargain" property. For example, a house is appraised at $200,000 and available for only $150,000. Certainly, there are cases in which a property is available for a real discount of 25 percent, particularly if the property is in disrepair or the seller is extremely motivated as in the case of a divorce or foreclosure.

Absent motivating circumstances, however, if the property in question sells for $150,000, the comp has been established for this house. The value of the property is what it sold for, regardless of what the appraisal shows. Many houses are listed on the MLS as "priced below appraisal" and, in fact, sit for months without selling. If a property was listed on the MLS at $150,000 for six months when the average number of days on market in that price range is 96 days, does the $200,000 appraisal mean anything? Obviously not!

A word to the wise: When you're doing comparable sales, look at the sales history of the property itself. Knowing if it was previously listed, relisted, or sold helps a great deal in determining a property's true value. Don't buy a house you think is worth $200,000 just because it's appraised for $200,000. Do your due diligence.

Estimate Repairs Accurately and Carefully

One area in which both new and experienced investors often run into trouble is estimating the costs of repairs and how this affects the current and potential value of a property. Looks can be deceiving. What appears to be a minor problem can often end up costing a lot to fix. Even if you don't plan on doing any of the work, you still need to know how the current condition of the property affects its market value. Obviously, two identical houses side by side are not worth the same amount if one needs substantial repairs.

Be sure to follow these rules:

- Do the math correctly.

- Don't do the work yourself.
- Estimate high on repairs.

Do the math correctly. If a house is listed for $180,000 and needs $20,000 in repairs, it should be worth $200,000 when fixed up, correct? Theoretically the answer is "yes," but then why bother with the headache and risk of a rehab? You should look at the least to double your money on the rehab, thus you should pay $160,000 (or less) for the house. The bottom line is that you need to know the current "as is" value as well as the "after-repaired value." The as-is value of a house should be a lot less than its value after it's repaired, less repair costs, because a house that needs $20,000 in work lacks market appeal and attracts fewer buyers. In other words, you want to discount the property more than the dollar value of repairs needed.

Our Advice: Get Appraisals for "Before" and "After" Values

When you purchase a property using institutional financing, the lender requires a professional appraisal. Ask the appraiser for two values: an "as is" value and an estimated value after certain repairs are completed. Be prepared to give the appraiser a written list of repairs you intend to make on the property.

It's important to do research that will give you a basic idea of the cost of common home repair projects. At the very least, spend time browsing home repair stores to become familiar with the costs of building supplies. Call a few contractors or "handymen" to estimate labors costs.

Don't do the work yourself. Many novice investors evaluate the cost of the labor by assuming they'll do some or all of it themselves. This is generally a mistake for several reasons. First, your time is more valuable than a contractor's time, so it's best to hire out the help. If you get a particular "Zen" from plumbing, that's great, but replacing toilets isn't the best use of your time.

Second, most investors are unskilled or lack the necessary time to devote to rehab projects; this causes frustration with an extended rehab project. Finally, what if you're injured or have a family emergency and can't complete what you started? Always assume you'll hire people in the trades to help and figure this cost into your purchase price.

Estimate high on repairs. Novice investors often delude themselves about the necessary rehab costs. The following story illustrates how investors should approach estimating a rehab project.

Legend has it that Tiger Woods was playing golf in a tournament with the late Payne Stewart, another great golfer. They were tied at even par. On one particular hole, they both hit their drives down the fairway and their balls landed about 100 yards from the green. Payne's ball was just a few inches behind Tiger's, so he would take the next shot. Payne asked his caddy how far he was from the hole. "One hundred yards," his caddy replied, handing him a club. Payne hit the ball, which landed ten feet from the hole. Tiger turned to his caddy and asked, "How far?" His caddy replied, "Ninety-seven yards," and then handed Tiger a club. Tiger hit his ball six inches from the hole. Payne turned to his caddy and angrily demanded, "Why did you give me a round number and Tiger's caddy gave him exact yardage?" Payne's caddy replied, "Because you're not as good as Tiger Woods."

The lesson here is that most investors are not good enough at estimating repairs to guess exact numbers. Instead, it's best to think in increments of $5,000 or $10,000, always rounding high. For example, an investor who's talented at estimating repair costs may come up with the figure of $7,200 to rehab a property. A "guestimating" investor may come up with a similar number, but should round it up to $10,000 to play it safe.

Bill's Advice: Be Very Conservative on Old Houses

If you're looking to purchase older homes, consider the "Hoffa Factor," that is, the odds that when you open up the walls, you might find Jimmy Hoffa buried there!

Joking aside, rehabbing old houses frequently comes with surprises that you don't discover until you start taking things apart. Therefore, we suggest that novice investors estimate as high as 50 percent more on repair budgets for older homes.

Ideally, you already have a trusted contractor on your side. Good contractors have the experience and expertise to provide a quick, accurate estimate of needed repairs. Even so, always estimate high on repair costs and cost of materials. Our experience has consistently shown us that two things are inevitable when rehabbing a property:

- It always *costs more* than you think it will.
- It always *takes longer* than you think it will.

As with market conditions and property values, be defensive. Estimate conservatively on repairs and you will be pleasantly surprised if it costs less.

It's essential to know how to valuate a house quickly and accurately because you can't determine whether you have a good deal unless you know what the property is currently worth. Being defensive means being as dead-on accurate as you can with the realistic value of a home in its present condition and what it will be worth after repairs or renovations.

Key Points to Remember

The most important concepts addressed in this chapter are:

- Comparable sales are generally the best way to assess a home's value.
- Knowing the costs of repairs is essential when determining a house's value.
- Always be conservative and estimate high on repairs.

CHAPTER

4

Determine Your Profit Before You Buy

"Look before you leap."

—Confucius

In this chapter, you'll learn the cardinal rule of real estate: *You don't make your money when you sell; you make your money when you buy.* This means that, as an investor, you shouldn't buy houses with the assumption that you'll figure out how to make a profit later. Instead, you need to ensure that you get a good deal—better yet, a great deal—when you buy a house so you see your profit up front. This chapter addresses determining your profit before you buy.

The Past Doesn't Equal the Future

Many people make the mistake of counting on earning a profit because of something that might happen *after* they buy, such as the property appreciating in value. While it's true that most properties generally do go up in value over time, this isn't always the case, especially in the short run. Unforeseen events may depress property values in the area.

Beware that many investment gurus use this emphasis on appreciation as a tactic when they're trying to persuade prospective clients to accept their advice about investing. They'll often use a pitch along this line: "If you had used this strategy of ours ten years ago, you would have realized a 100 percent return on your money." Hindsight is always 20/20 and every economist is a genius when looking back.

When you're investing in real estate, never presume that a property will increase in value. Don't be controlled by the blind hope—based on the fact that the property's value rose in the past—that it will continue to appreciate if you hold it for another few years.

Over the long run, the real estate market always seems to correct an investor's mistakes. Values go up and down in cycles in the short run, but over 20 or 30 years, the market tends to go up at a steady, conservative pace. History has shown that real estate has almost always outpaced inflation over the long term. However, if you're looking at the short term and counting on a three- to five-year strategy because real estate values went up over the past few years, you may be taking an unnecessary risk. A more defensive strategy is to make your profit from the start by getting the proper discount when you purchase a property.

Comparing real estate investing with the stock market. To grasp the idea of up-front profits and their importance in a real estate deal, it's helpful to compare real estate and the stock market. When you buy a stock below value, you assume that it's undervalued. Thus, for you to realize a profit, your stock must go up in value.

With real estate, the concept of value is different. Value is regarded as what a property will sell for today. For example, if similar houses are selling for $100,000 in a neighborhood, buying a property for $50,000 is a bargain because you can realize a profit by selling it quickly at its current value: $100,000.

In real estate, a particular investment is a deal in one of four cases:

1. You can buy it below it's current market value
2. There is some upside potential, such as a change of use, better management or additions and improvements that can be made to the property
3. It will provide sufficient income in relation to the purchase price
4. Future market appreciation.

The latter two cases are very similar to the stock market in that they are driven by earnings per dollar invested or future speculation, both of which are market-driven. The first two cases are generally based on seller distress or mismanagement, neither of which have much to do with the local real estate market.

In the stock market, a business may have a good plan but lacks capital; therefore, an investor can supply the necessary capital in exchange for future profits. In real estate, a seller's distress can mean profits for a buyer. Certainly market timing opportunities exist in real estate, but regardless of the market, one thing is constant: Individuals are often in distress.

Reasons for their stress might include:

- Divorce
- Job loss
- Foreclosure
- Death
- Lack of interest in the property

Thus, even if you think there are no deals in your town because it's a seller's market or there's no growth opportunity, *someone* always fits in one of the categories. Someone always exists who will sell you a property for less than fair market value. These people are called *motivated sellers*.

Find Motivated Sellers

The key to getting great real estate deals in any market is finding motivated sellers. After all, only those who absolutely need to sell are going to price their homes well below market value or accept unusual financing arrangements.

Generally, motivated sellers are facing some kind of crisis or hardship such as divorce, unemployment, or financial instability. In these cases, the property and the expenses of owning that property are one of many problems these people must deal with. Therefore, they're usually eager to get rid of their properties.

Here is your dream scenario: A property owner says, "That's it, I want out. I can't take it anymore. I've got to sell right now. I've just got to get rid of this house."

How do you find these motivated sellers? Fortunately, that isn't difficult to do these days because many motivated sellers exist out there. Start by scanning the classified ads for "For Sale by Owner" properties. Look for key words that signal distressed sellers such as "must sell" and "needs work." Basically, look for anything that implies desperation or urgency on the seller's part.

You can also take a proactive approach by advertising that you're looking for properties. It's important to emphasize that you'll pay quickly for homes. The lure of fast money will help you reel in distressed sellers.

When it comes to finding distressed homeowners, a little detective work also comes in useful. Search public notices and courthouse records for owners who are delinquent on their property taxes or are in some stage of the foreclosure process. There's a good chance these people are having money problems and may be eager to sell their homes before a foreclosure is complete.

How to Analyze a Potential Deal

When you find a motivated seller, consider whether that person's property is a good deal or not. Before you can do this, determine your plan for this property. Too many novice investors just assume, "Everything in this area has gone up, so I ought to invest." In other words, before you buy a property, construct a viable plan including an exit strategy. (You'll learn more about exit strategies in Chapter 7.) The key point here is this: *Never go into a deal without knowing exactly how to exit it.* The lower the purchase price relative to the current market, the higher your profit potential will be.

A "Good Deal" Can Vary from Place to Place

When it comes to determining a good deal, no cut-and-dry formula works for every market. In some areas, you can pay 90 percent of market value and still make a substantial profit, especially when demand is high. In other places, you may need to obtain a property for 70 percent of market value or less to be confident that you'll do well. Once you become familiar with an area and have completed a few deals, you'll get a feel for the market and know exactly what kind of discount is necessary to consider buying a property and calling it "a good deal."

Unfortunately, this means that you'll be less likely to spot a good deal when you first start out. Therefore, if you're a novice investor, we suggest you accept the fact that you'll miss out on a few good deals by taking a defensive stance. Being too aggressive can lead to borderline deals—deals that don't provide much profit. It's better to let a few deals slip through your fingers rather than take a chance on properties that end up costing you money.

Knowledge Is Power

The keys to analyzing a good deal are *knowledge* and *education*. In real estate investment, a strong correlation exists between knowledge and risk. The more knowledge you have about properties, markets, mortgages, financing, neighborhoods, local rent rates, repair costs, and so forth, the less you risk losing on a deal.

CLEAR System of Analyzing Deals

A great way to determine whether a deal is good is to use our CLEAR system. CLEAR stands for:

- **C**ash flow
- **L**everage
- **E**quity
- **A**ppreciation
- **R**isk

Let's analyze each of these concepts.

Cash Flow

Cash flow is an important consideration when you evaluate a potential deal. Your first priority is to determine whether a property will provide you with positive cash flow. This depends on a number of factors such as the state of the local rental market, the amount of financing, and the interest rate you'll be paying. Be sure to compare the cash flow potential of a particular property against that of other properties you're considering.

It's important to do "real math" on income properties. What do we mean by this? Let's look at "fool's math" for income properties. Novice investors generally do the following math for rental properties:

Monthly rent	$1,000
Monthly mortgage payment	$ 800
Monthly profit	$ 200

However, when you apply for a loan, most lenders will discount the rental income on your existing properties by 25 percent because there are other costs (see below) involved in operating a rental property. Therefore, using the above figures, you'd be in the hole by $50 a month (that is, $1,000 – $250 vacancy – $800 mortgage payment). Our experience shows that a 25 percent discount is generally correct. Rental properties involve much more than "rent versus mortgage payments" because expenses include:

- Taxes
- Hazard insurance
- Vacancy
- Repairs
- Management (there's a cost, even if you manage it yourself)
- Evictions and legal fees
- Maintenance
- Utilities
- Advertising

With multiunit residential rental buildings, these expenses can be as much as 50 percent of the rental property's income. Of course, they'll vary depending on local vacancy rates, the type of neighborhood (for example, there may be more vandalism, repairs, and turnover in low-income areas), and the age and condition of the property when you bought it. As with repairs, always estimate high on expenses. (Refer to the sample expenses in Property Cash Flow Analysis form in Appendix 3 to get a better idea of the real math involved.)

Several traditional income formulas for real estate are applied to income properties, although less commonly to single-family rentals. We suggest you take time to become familiar with these common formulas and use them to compare income properties.

Gross operating income. Gross operating income refers to the scheduled income of the property minus allowable vacancy. If the property is currently vacant or rented below market, you could use the potential income amount, using conservative figures. Don't compare rents to a building much nicer or in a better location, but rather a property that is similar to yours. You can send a "spy" (friend) to check out the property and act as a potential tenant, or check online Web sites like **www.rentclicks.com**.

Operating expenses. Operating expenses include just about everything else except paying mortgage debt. This includes maintenance, management, insurance, taxes, and all the other expenses listed in the Property Cash Flow Analysis form in Appendix 3.

Net operating income. Net operating income is gross operating income less operating expenses, as explained earlier.

Capitalization rate. Capitalization rate (also called the cap rate) is the net operating income divided by the value of the property. This doesn't take into account the financing and is a measure of a property's value compared to income it will provide. For example, if you own a property worth $100,000 that has a net operating income of $10,000 a year, your cap rate is 10 percent. If you own it free and clear without a mortgage, you have more cash flow than if you paid a mortgage each month, but doing that only changes your cash flow, not your cap rate.

Cash on cash return. Cash on cash return is the annual rate of return you're getting based on the cash you invest. This number will be higher the less you pay for the property and the less money you have invested in the deal. As an example, let's use the same $100,000 property that has a net operating income of $10,000 a year. If you invested $10,000 down on this property and have a $90,000 mortgage with an annual payment of $9,000, your cash flow annual is $1,000 and your cash on cash return is 10 percent. If you put $40,000 down and have a $50,000 mortgage, your cash flow would increase, but your cash on cash return would go down.

These are just formulas; they don't take into account anything other than the income of the property. However, they provide useful benchmarks for comparing one property against another for income potential.

Leverage

Next in our CLEAR system for determining a good deal (after cash flow) is leverage. Because of inflation, a dollar today will generally be worth less in the future. Thus, while real estate values may increase, an all-cash purchase may not be economically feasible because you could use your cash in more effective ways. As you can see from the previous cash on cash return example, more cash invested into a deal may increase cash flow, but may not maximize the return on your capital.

Understanding the Concept of Leverage

Leverage is the concept of using borrowed money to make a return on an investment. Let's say you buy a house using all your cash for $100,000. If the property increases in value 10 percent over 12 months, it is now worth $110,000. As a result, your return on investment (ROI) is 10 percent annually. (In actuality, you would net less because you would incur costs when you sell the property.)

However, if you purchase a property using $10,000 of your own cash and $90,000 in borrowed money, a 10 percent increase in value would still result in $10,000 of increased equity, but your return on cash is 100 percent ($10,000 investment yielding $20,000 in equity). Of course, the borrowed money isn't cost-free; you incur loan costs and interest payments when you take on a loan. However, you could also rent the property in the meantime, which would offset the interest expense of the loan.

Please note that ROI is not the same as cash on cash. As you can see in the examples, appreciation on the investment was considered in the equation. Cash on cash return is simply the cash you get each year versus the cash you have invested. The return on investment (ROI) calculation considers the total profit including appreciation.

Taking the concept of leverage a step further, you could purchase ten properties with 10 percent down and 90 percent financing. If you could rent these properties for breakeven cash flow (that is, actual expenses and mortgage payments not exceeding actual income), you would have built up a large nest egg in 20 years when you pay off the properties. Balance that with what you could make by investing the cash flow on one free-and-clear property for 20 years; you would have maximum cash flow each year, but your total portfolio would not increase nearly as much.

Why is leverage important when you invest? Because the less cash you put down on each property, the more properties you can buy.

Many investors ask us, "If leverage is so important, what about the 'no money down' deals?" Many people like to buy real estate with no money down because it's the ultimate form of leverage. In addition, this may also be their only option if they have no cash available at the moment. Keep in mind, though, that there's nothing special about buying a property with no money down; the deal must also make sense in terms of profitability at some point.

On the other hand, if you can purchase the property at a substantially below-market price and with no money down, you have the perfect combination for a good deal. This is buying 100 percent loan-to-purchase (LTP), not 100 percent loan-to-value (LTV). Figure 4.1 illustrates the difference between LTP and LTV. Investors should strive for high LTP and low LTV.

FIGURE 4.1 LTP versus LTV

Price	Value	Loan	LTV	LTP
$100,000	$100,000	$100,000	100 percent	100 percent
$ 80,000	$100,000	$ 80,000	80 percent	100 percent

If you can buy below market and close to 100 percent loan-to-purchase (LTP) with breakeven or positive cash flow, you'll go to real estate investor heaven!

The problem with buying a property at a below-market price is that lenders tend to "penalize" investors with their loan regulations. Fannie Mae (FNMA) conforming loan guidelines usually require you to put up 20 percent of your own cash as a down payment. The 20 percent rule applies even if the purchase price is half of the property's appraised value. Thus, the loan-to-value (LTV) rules are based on appraised value or purchase price, whichever is less.

Seasoning May Be Necessary When You Refinance a Property

Refinancing is generally based on loan-to-value (LTV), not loan-to-purchase (LTP). Thus, if you can buy a property below market using cash (using a source such as your home equity line of credit), you can refinance the property based on its appraised value and be close to 100 percent loan-to-value on the property with little or no money in the deal. To refinance based on the property's value (assuming it's higher than the recent purchase price) a lender generally requires six months or more of ownership. This is called *seasoning*. Some lenders will refinance a property without seasoning if you have excellent credit.

Leveraging real estate deals is great if the properties go up in value because the rate of return on your money goes up exponentially. However, if the properties go down in value and you have a lot of debt on them, the result will be negative cash flow.

Is negative cash flow necessarily a bad thing? Well, yes and no. If you have other sources of income and are looking for long-term appreciation, you can consider negative cash flow the equivalent of payments into a retirement plan that will eventually pay off. This leads to a discussion on equity, the next concept in the CLEAR system after cash flow and leverage.

Equity

Remember, our goal with the CLEAR system is to determine if purchasing a specific property is a good deal. Therefore, you need to determine how much (if any) equity the property has. You can find equity in many forms, including a foreclosure or other distress situation in which a property has a discounted price, a fixer-upper offering lots of potential, or a poorly managed income property. You can also create equity by rezoning a property—changing its use from commercial to residential or vice versa. For example, buying a house on a main street may not be appealing, but if the area gets rezoned for commercial use, this house can be converted into an office or a retail storefront and prove to be a good investment.

With financing involved, equity can take the form of a paydown on debt. For example, a rental property with income can be used to pay down financing, known as *amortization*. Each mortgage payment is part principal, part interest. As you collect rent and make mortgage payments, the principal payment increases your equity in the property, even if the value does not increase.

Appreciation

The fourth concept in our CLEAR system is to determine the property's probable appreciation. Jumping into the right neighborhoods at the perfect time can result in appreciation and profit. However, it can be tricky to time this exactly right.

Depending completely on appreciation for your profit is risky. Instead, buying for moderately long-term (ten to 20 years) appreciation is safer and easier. Study the long-term neighborhood and citywide trends to choose areas that will hold their values and grow at an average 5 to 7 percent annual rate.

Calculate Appreciation as Net of Inflation

Note that appreciation should be calculated net of inflation. For example, if inflation is 3 percent annually, a 5 percent increase in property values translates into a 2 percent gain. In inflationary terms, this is described as "nominal" (numbers) versus "real" (inflation-adjusted) or "net" value.

You can find information on annual inflation at the U.S. Department of Labor Statistics at **www.bls.gov**.

Risk

The final concept in the CLEAR system to assess the risk involved in a particular property investment. Unfortunately, many investors don't spend nearly enough time considering risk. Virtually every real estate deal involves at least some element of risk, no matter how "safe" it may seem. Because real estate purchases most often involve debt, an initial investment of cash can turn into a huge liability if an investment turns bad. There are also potential legal liabilities involved in real estate, which are discussed in Chapter 8.

We suggest you always have a Plan B in case your initial plan goes awry. Know the answer to this question: If you buy a property for short-term appreciation and it doesn't appreciate in value, can you rent it for positive cash flow until the market rebounds?

Also take financing into account when you're considering risk. Many novice investors buy properties with adjustable rate loans assuming that they'll sell the property for a profit before the loan payments increase. If you do that, consider this question: If you buy a property with an adjustable rate loan and the rates go up, will this put you out of business? If you have a few vacancies, can you handle the negative cash flow or will it break the bank? In other words, expect the best but prepare for the worst.

Bill's Advice: Look at a Wide Range of Risk Factors

When considering risk, also consider the headache and liability involved in your investments.

At one time, I considered investing a few hundred thousand dollars in properties in Kansas City, Missouri. An investor was liquidating a portfolio of 22 houses that he owned free and clear, and would owner-finance with a sizeable down payment. The houses were worth about $30,000 each, and each one rented for about $300 a month. On paper, it seemed like a great deal because it would yield $6,600 a month in income. After careful consideration, however, I passed on the deal to buy one single-family rental in Boulder, Colorado, and one condominium in Denver, Colorado. They rented for a total of about $2,500 a month.

Why didn't I go for the deal in Missouri that seemed more lucrative? First, the Kansas City properties were older than those in Colorado were and located in poor neighborhoods. While the income was better for these 22 houses, so was the potential for crime, management hassles, liability, and repairs. Remember, putting a roof on a $30,000 house in Kansas City costs the same as putting a roof on a similar house that's worth $200,000 in Boulder or $500,000 in Boston.

Second, it's much easier to manage two tenants than 22 tenants. Regardless of the property values, dealing with more tenants and more properties means more headaches and more liability.

When you're considering risk, also pay attention to possible tax law changes. Rental properties can provide a good tax break for those who qualify because of their depreciation factor. While real estate does increase in value, the IRS allows a large deduction for the theoretical depreciation of the property improvements, which can often create a loss, at least on paper. For some investors, a negative cash flow is a large loss that offsets other income.

However, as many investors learned in the 1980s, "what the government giveth, it can take away." With the Tax Reform Act of 1986, the U.S. Congress suddenly and drastically changed rules on deducting losses on rental property. Before that time, many investors bought properties that did not make financial sense, except for the tax write-offs. When the laws changed, many investors simply walked away from these properties, causing massive foreclosures that significantly hurt the housing market. We hope that investors learned from this debacle and won't make the same mistake. In other words, don't just buy a property because it's a good tax break because that risk factor could change overnight.

Balance Your Business with Your Personal Goals

You must balance using the CLEAR system with your personal goals. For some investors, cash flow isn't as important as retirement income or equity growth. For others, they need income right now to quit their job and, thus, owning rentals may not provide enough income. If you have a full-time job or business, rentals or rehabs may be too time consuming. In short, do the math and consider all the implications of your real estate investments.

Gary's Advice: It's Critical to Follow Your CLEAR Plan

Over the many years I've been in this business, I have encountered numerous successful investors and many others who struggle. I can boil down the difference into one statement: The successful investors had a CLEAR plan and followed it through.

I advise first-time investors to purchase one good house a year for ten years using the CLEAR formula and hold them. At the end of ten years, they would have a million dollars in net worth. This advice is as valid now as it was 30 years ago. I know this because investors who tried to buy the latest hot property in the latest fad areas are now struggling to be successful.

It doesn't matter what your plan is; what matters is that you approach each property using the CLEAR formula. Keep in mind that it's more about *quality* than quantity.

Key Points to Remember

The most important concepts addressed in this chapter are:

- As an investor, you can never take profits for granted. Be sure to analyze and go for the best deal at the onset of a transaction.
- The ability to locate (and deal with) motivated sellers is critical to realizing profitable deals.
- The CLEAR system can be an efficient way to analyze a potential deal quickly.

CHAPTER

5

Always Invest in "Safe" Deals

"Take calculated risks. That is quite different from being rash."

—George S. Patton

People who've always put their money in blue-chip stocks, bonds, and money-market accounts commonly think of real estate as being an inherently risky investment. While real estate can be risky, you can certainly limit that risk by educating yourself. Our experience shows that certain types of investments in real estate can be inherently safer than others, particularly where there is uncertainty in the future of the market, whether it will go up or down.

After all, real estate is a survival game—anyone can make money in rising markets, but those who survive the down markets retire wealthy. Stick to this fifth principle—always invest in "safe" deals—and you'll survive long term in this business. Remember, there is no 100 percent "safe" deal, but being thoughtful, conservative, and defensive will increase your odds of long-term success in real estate investing whether markets are up or down.

Invest in Deals, Not Markets

Too many novice investors try to time the market and ride the waves of market appreciation. Certainly buying and selling at the perfect time (when the market peaks, for example) is the easiest and most lucrative way to invest in real estate. It's also the most risky because few people have enough foresight to figure out where the top and bottom of the market are.

Instead of trying to guess the bottom and top of a market, stick to particular deals that make sense. In any market, by applying our CLEAR formula from the previous chapter you can find particular bargains in solid neighborhoods that make sense.

Buying houses at great bargains is easy when the market is soft and sellers are flexible. Even if you're in a hot market, you can still find homeowners who want to sell below market for reasons other than money, including the stress of a divorce, a death in the family, a job transfer, or other life changes. At times like these, people can be highly motivated to sell their houses quickly. If you're in a flat or falling market, you can either invest elsewhere or stay in your farm area and buy extremely cheap. Even if you seek emerging markets around the country, you can still end up with a bad deal that won't make you money. In short, each deal must stand on its own.

The late Will Rogers said, "Buy when others are selling and sell when people are buying." This may work for stocks because you can get in and out of a deal in a short time. However, in real estate, you can't expect to time the market in terms of days. Unless you're in a market where bidding wars occur and prices go up in a matter of days, plan your strategies in terms of months and possibly years.

Stick with Metropolitan Areas

As mentioned earlier, housing markets are driven by people and people tend to go where there are jobs. The more people who live in an area, the easier it is to sell or rent a property, so stick with major areas that have a large, diverse population. As a rule, stay away from resort areas or smaller towns that have one major employer. (You may recall what happened to Flint, Michigan, in the 1980s when General Motors laid off a large part of its workforce, causing mass unemployment and long-term depression of the local housing market.)

College towns are usually an exception to this rule. They tend to do well because of the built-in population that lives there temporarily year after year. College rental properties tend to cost more, are seasonal, and are prone to high turnover and damage (remember the movie *Animal House*), but there's no shortage of college and graduate school enrollment across the nation.

Another good idea is to invest in towns that have the employer-equivalent of Disney World or a local government (e.g., the school system) that employs a significant percentage of the population. These people aren't moving anywhere soon.

Watch the latest trends when looking for metropolitan areas in which to invest. The revival of urban neighborhoods is a growing national trend. Once considered the haven for the poor, laden with crime and plagued by poor schools, these areas are coming back with a vengeance. Art galleries and restaurants are replacing burnt-out buildings. Boarded-up housing is being refurbished into stylish town homes. Many empty-nester baby boomers are selling their large, suburban homes and moving downtown to experience a hip urban way of life. Thus, proximity to the downtown areas in many cities has become more desirable than sprawling, suburban, middle-class neighborhoods.

Every city has certain neighborhoods that are more desirable than others are. These areas always seem to hold their property values in down times and increase exponentially in good times. It may be because of proximity to downtown or the strength of a particular school district, but pound for pound, properties in desirable areas are worth more than houses in areas that don't have the same features. You may not find great bargains, but they're always safer investment bets over the long run than newer developments or super cheap areas.

Buy the WOB in the MOB Near the Blob

As a rule of thumb, the worst house on the block in a median-priced neighborhood (or below) is generally a safe bet for investing. We call this buying the WOB in the MOB near the Blob. Spelled out, this is:

- buy the WOB (**W**orst **O**n the **B**lock)
- in the MOB (**M**edian price **O**r **B**elow)
- near the Blob (see explanation below).

Now, let's break this down, step by step.

Worst on the Block (WOB)

The worst house on the block in a good neighborhood is always a better investment than the nicest house in a lesser neighborhood for two reasons. First, most people would rather live in a better neighborhood than be king of a slum. They like to brag that they live in a particular neighborhood, even if it's the cheapest house in it.

Second, there's always more room to push the values on the low end of the spectrum than on the high end. As we discussed earlier, appraisers look at comparable sales within a particular neighborhood. If your house is already the highest priced for the area, there's not much you can do to improve its value. However, if your house is priced on the low end for the area, you can fix it up and stretch its value. Appraisers are more comfortable stretching the price per square foot of a cheap house than stretching the total price of a house that's already at the high end of the neighborhood. Remember: *Market value is what someone is willing to pay for a house.* A nicer house will generally sell for more per square foot than a bigger one that's not as nice.

Median Price or Below (MOB)

As you may recall, the median price marks the "middle of the pack," with half of the housing in that area selling for less, half for more. The below-median price range within a metropolitan area is generally a safe investment because there's a growing shortage of these houses.

New homebuilders have certain fixed costs involved in building new subdivisions. These costs include paving roads, installing power and sewer lines, and maintaining a large staff. While more expensive homes can take longer to sell, in the long run, those builders make more money because of the economies of scale. It only takes a few extra two-by-fours to make a house that's 3,000 square feet versus a house that's 2,000 square feet and the profit margin on the extra size is all gravy to the builder.

Because of land restrictions and costs, most of the newer developments are being built farther and farther from the center of town. As discussed earlier, the inner-city housing demand has increased; many smaller houses are being knocked down, refurbished, or rebuilt. Thus, what we have is a shortage of affordable housing. With mass immigration into the United States, the demand for affordable houses within proximity of the metropolitan areas will continue, particular for rental properties. Investors who own housing in the MOB will find their properties retaining value in the long run.

The "Blob"

Remember the movie *The Blob*? In this movie, a giant monster oozed from place to place, taking everything and everyone in its path. The same effect often happens in neighborhoods. If a particular area is hot and desirable, it will eventually run out of room and the closest geographical neighborhood will generally be next. In some cases, hot areas may greatly exceed the median price, thus possibly increasing the investor's risk because it's not the desired median price or below. Investing in more reasonably priced homes in close proximity to this desirable Blob neighborhood may be a safer bet.

When considering the Blob effect, take into account neighborhood dividing lines. In some cases, it's simply a road. In others, it may be a hard, impassable line, including a railroad track, major highway, or body of water. Paris is a good example of a city with a strong dividing line. If you've visited Paris, you've seen the neighborhoods on the Right Bank and the Left Bank of the Seine River. It's clear to see how the neighborhoods on either side of the river differ.

All things being equal, the worst house on the block in the median-price neighborhood or below near a hot and growing area is your safest and best investment in any market. Certainly when prices are rising, a new condo by the beach or a 10 percent appreciation on a million-dollar house seems like a good way to make a fast buck Nevertheless, being a defensive investor means going with the lowest-risk investment on a consistent basis, not shooting for the moon. Ask any good football coach the key to consistently winning and it's not the "hail Mary" pass. It's making first down over and over by moving the ball down the field a few yards at a time.

Look Where a New Starbucks Opens

Have you noticed that Starbucks coffee shops are popping up in "up and coming" areas? Big companies like Starbucks do a lot of research before they open a store that sells four-dollar cups of coffee. Why should you reinvent the wheel? Let the pros do your initial research. They're probably more experienced than you are! If you see a Starbucks going up in a transitioning neighborhood, that may be your green light to go ahead and buy there.

Fixer-Uppers

Fixer-uppers are almost always a safe bet if you buy them right. As we mentioned earlier, fixer-uppers generally have less market appeal than houses that are in good shape. This translates into less demand and a lower purchase price. However, be extremely careful about what kinds of projects you take on—not all fixer-uppers are worth the effort. Despite what you see on the cable television shows, a fix-and-flip property isn't just about fixing things. It's about knowing what things to fix, how to estimate the repairs, and whether such an endeavor is even worth the effort.

What Should You Fix?

While you should be systematic in your approach to rehabs, keep in mind that every property is different. Location, age, potential value, and the architectural style of a property all affect how to approach any renovation. The condition of the property and the scope of the needed repairs will also affect the rehab process.

Certain improvements will always give you the most bang for your buck—namely, kitchens and bathrooms. Remodeling kitchens and bathrooms and adding bathrooms will give you the most return on your money. However, if you plan to keep the property as a rental, adding more livable space may get you more rent, depending on how much existing space is in the house already. For example, if the house is a small, two-bedroom ranch, converting the garage into one or two bedrooms may be worthwhile if plenty of parking is available other than in the garage.

Generally, decks, pools, patios, landscaping, and expensive flooring don't add much value. Certain "overkill improvements" don't add much value either. This includes spending more money than necessary on appliances, roofing, heating, plumbing, and sprinkler systems. For example, if the house has an old roof, you must fix it, but adding a roof with a 30-year warranty versus a ten-year warranty won't get you more money when you sell the house. Likewise, an energy-efficient appliance that costs you twice as much as a typical appliance isn't going to bring you more money for the house. If something is old or broken, fix it, but don't overspend unless the extra money visibly adds to the marketability of the house. In many cases, if it looks clean, replacing an ugly or broken appliance with a newer used one works fine. Kitchen cabinets can often be painted over or refaced instead of replaced entirely. Moreover, if you do choose to replace the cabinets, spend a little extra on the handles for an extra designer's touch.

Appraisal versus Appeal

It's important to understand the difference between improvements that will affect the appraisal value versus the marketability or "appeal" of the property. For example, using granite slab countertops versus Formica will not significantly affect the appraisal of the property. The issue for the appraisal is whether the kitchen was remodeled or not. Granite slab may cost you $3,000, but add only $1,000 to the appraisal. Therefore, why would any investor add such an extravagance if the property won't appraise for more? The answer is "appeal."

While appraisers look unemotionally at facts like a house's square footage, buyers are emotional people who can get hooked by a classy-looking kitchen countertop. If a buyer loves your house and is willing to pay more for it, then it should appraise for the actual purchase price. That's why appraisers consider comparable sales of similar homes in the neighborhood. Technically, they are required to consider the details of the sale and are provided with a copy of the sales contract, which includes the price and details of the sale.

Human nature being what it is, appraisers tend to appraise to the contract price unless the price is completely out of line for the neighborhood. This is why it's crucial to remodel houses on the "inexpensive" end of a neighborhood than on the high end. If the house you are selling is on the high end and you attempt to push the price beyond the highest comp, it gives the appraiser nothing to justify your price. On the other hand, if your house is on the low end, there are other sales to justify the price even if comparable houses are bigger than yours is. Appraisers can record notes in their reports that your house was better remodeled than similar houses in the neighborhood that sold for less.

Keep in mind that if you're getting an appraisal for a refinance, you have no buyer in love with your kitchen to push up the house's value. Appraisers are human beings who are impressed with nice-looking houses, but they won't be swayed like a buyer who thinks about calling this house "home" and wants a higher value to it.

Bill's Advice: Be Cheap, but Don't Make Your House Look Cheap

You can spend a minimal amount and still make a house look inviting. We typically spend less than $15,000 on a complete renovation of a 1,200-square-foot home, which is generally half what other investors spend. The key is to spend the minimum on items that are expensive, and the maximum on things that are inexpensive, but visible, as noted next.

Doors, electrical switch plates, faucets, door knobs, and light fixtures. Overspend on these hardware items because they will add "pizzazz" without affecting your total budget much. For example, a $100 light fixture will look incredibly nice in a basic house compared to a

$30 fixture. Will $70 break your budget? Of course not! Use fancy $15 door handles instead of plain ones. After all, there are only about seven doors in a small house. If your house has only one level, replace old brown doors with new six-panel hollow-core doors. It shouldn't cost you more than $200 a door, including materials, labor, handles, and paint. Instead of using cheap plastic switch plate covers, upgrade to nice ones for about $60.

Upgrade the tile. If you are replacing the kitchen and bathroom floors with new tiles, spend extra for really nice ones. If the total square footage of the kitchen and bathrooms is 200 square feet, then using $2 tiles versus $1 tiles will affect your budget by only $200.

Watch for hidden hazards. Be sure to go through an extensive inspection process before closing on a property. Sometimes what seems like an easy rehab will turn out to be an environmental nightmare. For example, water damage can lead to black mold, which threatens health and can be expensive to get rid of. Lead-based paint, which was used before 1978 but has been phased out, can be expensive to remove. Asbestos is another hazard. If insulation made with asbestos is discovered on ductwork over dirt, the dirt needs to be tested to see if it has been contaminated by pieces flaking off, which usually happens. Radon is common in certain parts of the country and houses should be inspected for this.

Finally, be aware of "meth" houses, that is, houses in which methamphetamine was prepared or stored. Your county health department may have a list of houses that were identified as meth houses. Once flagged as a meth house, a house must be completely renovated by an OSHA-certified (U.S. Department of Labor Occupational Safety and Health Organization) contractor, which is an expensive process.

How nice should the house be? Before you get involved in a fixer-upper, assess the neighborhood carefully to determine the scope of your repairs. Do you want your house to be consistent with those in the neighborhood, or do you want to make it a little nicer? You can easily overdo this if you're not careful, so don't go overboard regarding quality of materials, time spent on minor details, or unimportant prob-

Gary's Advice: Look Out for Fixer-Upper Cost Killers

Some minor but expensive hazards you may have to deal with include single-strand aluminum electrical wire, polybutylene water supply pipe, termites, hidden water damage, and Masonite Woodruf roofing. Always hire a qualified home inspector who has experience in these issues and other building code issues before you buy a fixer-upper.

Make sure you hire a professional inspector to assist you with the inspection of the house until you become more experienced yourself. A professional inspector charges between $300 and $500 for a thorough inspection of a house from top to bottom. Choose an inspector who has experience with the particular neighborhood and model of house you are considering purchasing.

lems. *Focus on repairs and improvements that add value and make the property more marketable.*

Beginning investors commonly spend time and money on unnecessary projects. As a result, these beginners are pressed to ask premium prices for their properties, wasting time and money as they wait for their houses to sell. A rule of thumb is to tackle only projects that will bring you at least double your money back in profit. For example, if you spend $10,000 in repairs or improvements, you want to yield an extra $20,000 or more in net profit when you sell.

Remember, "net profit" includes what you have after paying all of your costs. Many novice investors mistakenly assume that buying a house for $90,000 and investing $10,000 in repairs means the house can be sold for $110,000 and bring in $10,000 in profit. This is not quite true. Here are a few "hidden" costs to be aware of:

- **Acquisition costs**—When you purchase a property, you may pay for various escrow fees, transfer tax (as high as 3 percent of the sales price in some areas), appraisal, inspection, and lawyer fees.

- **Loan costs**—The cost of funding a loan to purchase the property can be substantial for an investor. It could include points, "processing" fees, prepaid interest, and lender escrows for property taxes.
- **Holding costs**—The cost of carrying a property is more than you think. Calculate at least six months of insurance, property taxes, and utilities.
- **Broker commissions**—Statistically, 95 percent of all properties sell on the multiple listing service (MLS), which requires using a real estate broker. You can use a flat-fee listing service to save money, but you will likely have to pay a 3 percent commission to the broker who brings you the buyer.
- **Closing costs**—When you resell the property, you will have another set of escrow fees, title insurance, recording fees, and other miscellaneous charges.

In short, estimate at least 10 percent of the total purchase price to cover these charges, possibly more, depending where you invest. If you are unsure, ask a local real estate broker for a good estimate.

Our Advice: Know the Mathematics of Renovations

Many television home improvement shows and magazine articles cite statistics about the dollar return on an investment for different home improvement projects. Generally, we find they are correct in terms of what items are worth fixing and not. The confusing part is that they might say, "For every $10,000 you spend on the bathroom, you will increase the value of the property $8,000." Remember, investing is a for-profit business, so spending $10,000 to bring a return of $8,000—or even $10,000—simply isn't worth the effort. The key is to buy right, which means you must buy for substantially less money than the repairs will cost you.

It's crucial to understand that the renovation *itself* doesn't make you a profit; rather, it gets the home into "marketable" condition. The more repairs a home needs, the less appealing it is, and therefore the fewer potential buyers will be attracted to it. More than that, the market dictates that sellers must drop their prices to attract more buyers who are mostly investors. Most novice investors can handle cosmetic repairs like painting and carpeting, but any major projects usually discourage all but the most experienced rehabbers. That further drives down the "as is" market value of the house. Therefore, instead of thinking, "What can I fix to improve the value of this house?" it's better to think, "How cheap can I acquire this miserable piece of junk that nobody else wants?"

The key advice here is to *make your money when you buy.* Sound familiar?

Conversely, you never want to purchase the most expensive house in a neighborhood—just the cleanest. Standard items should be consistent with those in other nearby homes. For example, window air conditioners may be the norm in one neighborhood, but central air may be standard in another. That means you don't need to install central air conditioning in a window-unit neighborhood. Items such as sprinkler systems, security alarms, and storm doors aren't usually worth the cost and effort to install. On the other hand, be generous on the inexpensive items, such as ceiling fans, doorknobs, switch plates, toilet seats, faucets, trim, bushes, and other cosmetic items that add appeal without adding much total cost. New windows can sometimes be worth the price you pay, particularly in parts of the country where heating and cooling are big issues.

If you plan to buy a house for a rental, only spend money that will make the house safe or command more rent. As previously discussed, knowing the cost of the repairs is a crucial factor in the equation of how to approach fixer-uppers. Whether you do a complete rehab and resell it, do a light rehab and rent it, or resell the property "as is" to another investor, understand how to evaluate repairs (e.g., the scope and cost of the whole project) and how repairs will add value to the property.

Condominiums

Condominiums are traditionally the most volatile of real estate investments. Ask anyone who bought one in the 1970s or 1980s (your humble authors are no exception) and they'll show you the financial scars on their backs.

Condos have made a strong comeback in recent years because of the popularity of purchasing second homes, particularly in resort areas. Whether this trend will continue is uncertain, but keep in mind that condos are generally a tougher sell in most areas than single-family homes. Moreover, because condominiums involve a homeowners' association, you'll have to deal with management issues, rules, and costs that may be out of your control.

When buying a condo, consider your prospective tenant or buyer when you resell. Is it priced so high that your pool of buyers is limited? It may be in the median price range or below, but how many people live in one-bedroom condos? Is the development so old that the HOA (homeowners' association) dues are high and will continue to rise as the development ages and needs repairs?

For the most part, condos tend to fit into two categories: rentable and livable. Cheap condos that rent well often don't appreciate much in value. Using our CLEAR formula in Chapter 4, you can get away with buying a $50,000 condo and renting it for $500 a month forever. In 20 years, it may barely have appreciated above inflation. Yet a different condo near downtown or the beach may rent for negative cash flow and appreciate 10 to 15 percent a year.

In short, the normal formulas that apply to single-family homes aren't as consistent with condos, which is why defensive investors need to approach buying condos with extreme caution.

Our Advice: Look for Limitations When Buying Condos

Be aware that some homeowners' association rules restrict the rental of units, so make sure you check the limitations before you purchase a condo that you plan to rent out. In addition, many lenders have limitations on financing condos, including a requirement that owners occupy a certain percentage of the units. Find out all these details before you buy.

Multifamily Housing

Investing in multifamily housing can be a blessing or a nightmare, depending on whether you're cut out for management. While it's possible to hire a management company, few are good at dealing with small buildings. The cost per unit of multifamily housing is much lower than single-family homes, but the management factor and liability is exponentially higher. Moreover, financing is more difficult for multiunits, especially for buildings with more than four units that cost less than $3,000,000 in total.

In short, the normal formulas that apply to single-family homes are not the same with multiunit buildings, which is why defensive investors need to approach them with more caution than single-family homes.

Properties to Avoid

The WOB in the MOB near the Blob is a good rule of thumb for safe investments, but it is just that—a rule of thumb. Some investments may be an exception or a calculated risk, but general rules like this provide guidelines that both novice and experienced investors live by.

Likewise, pay attention to the rules of thumb for avoiding certain investments. Certainly exceptions exist, but the following tend to be more speculative and riskier for novice investors. You can certainly make good money at these, but it takes more experience and research. If you're a novice investor, we advise you to proceed with caution and be particularly defensive in your approach to these types of investments.

New or Preconstruction Properties

Properties are often sold before they are built during the "preconstruction" phase. Preconstruction properties, particularly condos, have been popular in many markets over the last few years. Some speculators have made a bundle buying up preconstruction condominiums in hot markets, and then selling them for 25 to 50 percent profit upon completion of the project, often a year later. Properly timed, a preconstruction condo purchase can be lucrative if there is limited supply (such as beachfront property) and a strong local market.

However, the basic premise of such activity violates one of our cardinal rules: *Make your profit when you buy, not when you sell.* If you're paying full price at what could be the top of a saturated market, you may find yourself stuck buying an overpriced property or bailing on a large earnest money deposit.

Bill's Advice: Find Out Builder's Policy on Reservation Fees

Builders generally require a certain amount of the selling price (anywhere from 1 to 5 percent of the sales price) as a "reservation fee" before the development is built. Most often reservation fees are refundable, but in such cases the builder may reserve for himself the right to back out and refund your fee.

It can be a Catch-22 because if you're *not* committed, neither is the builder, but if you *are* committed, you can lose money. The builder contract generally requires an additional earnest money deposit of anywhere from 5 to 10 percent of the purchase price when the building reaches substantial completion. Most often, this earnest money is not refundable.

If you sign a contract to purchase a preconstruction property, make sure the builder doesn't prohibit you from flipping the property after it's complete. Also, have Plan B ready. For example, if you can't sell the property, can you complete the purchase and rent the property to ride out a market cycle? Check the fine print to see what you're committing to and how much money you have to put up now and before the project is completed.

Keep in mind also that construction projects often get delayed for a variety of reasons, so make sure you're dealing with a reputable builder.

Properties in Weather-Dependent Resort Areas

Investing in seasonal resort properties that depend on weather, such as ski resorts and beach properties, can be risky if the weather doesn't cooperate. Most investors who profit from resort properties do so by appreciation, but that requires good timing—and a little luck. However, these tend to be risky ventures unless you don't mind owning a resort property as a second home and making payments out of your own pocket during the hard times.

Bill's Advice: The Math on Vacation Homes Doesn't Usually Work

Too many people talk themselves into buying vacation homes as a way to save money or as an investment. In fact, they are rarely a good idea.

For example, my family goes skiing an average of 12 weekends per year, which is about every other weekend during the season. A two-night stay averages $600 for the weekend, which ends up being $7,200 for the entire season. The typical condo we rent (we find it at www.vrbo.com) costs about $400,000 to buy. With 10 percent invested, a $360,000 mortgage costs about $2,400 a month, plus HOA dues, utilities, maintenance, taxes, insurance, wear and tear, and cleaning fees. That totals well over $3,000 a month or $36,000 a year. The condo would have to be rented every night from November 15th until April 15th to come close to breaking even in terms of cash flow. This is nearly impossible; ski condos generally rent for long weekends and a few holiday weeks. It doesn't take a complicated calculator to figure out that the math doesn't work unless the condo is in a rapidly appreciating market and is rented every weekend—which means I wouldn't get to enjoy it!

Upper-Middle-Class Homes

Traditionally, the type of house that first loses value when a market turns downward is the upper-middle-class home. If you purchase this kind of house as a rental property, it can be difficult to rent for even close to breakeven cash flow because of the limited market for renters who can afford high rents. Generally, when the economy turns downward, these homes get foreclosed and the occupants take one step down when they need to rent or purchase a house. That's where you should be buying—in the MOB (median priced or below)—and not the upper-middle-class homes.

Ironically, this trend doesn't apply to very high-end homes, which hold their value in soft markets. The super-expensive properties that are second-home and even third-home playgrounds for the rich are frequently owned free and clear. Therefore, these owners aren't as vulnerable as upper-middle-class, white-collar workers who live in their overleveraged homes as their primary residences.

Properties in Small, Rural Towns

Small rural towns that are far from major metropolitan areas and lack a college or resort attraction aren't the best bet for most investors. Many of these towns have one major employer that could lay off a large workforce or pack up and leave, crushing the town's economy. In addition, the potential pool of buyers or renters is small.

If you live in this type of town, you have two choices—invest elsewhere or be extremely conservative in estimating vacancy rates or resale time—and, of course, buy *really cheap*!

Mobile Homes

Mobile or "manufactured" homes can be risky, unless they're on their own parcel of land. If your home is in a park, you're at the whim of the park rules, which means your lot rent could increase or the lot owners could change the standards and not allow renters. If you read between the lines, owning a mobile park can be a safe bet; you collect rent for the lots and you can also sell homes in your own park.

Be careful to distinguish between *modular* and *manufactured* houses. A modular home is generally a prefabricated home that is built in pieces, shipped to a destination, and constructed as a unit. Modular homes are craned on-site and set on permanent foundations; once they're set in place they can't be moved. These homes are generally classified the same as regular "stick-built" homes for the purposes of financing.

Manufactured homes, which look similar, are built on frames and tied down. They can, in theory, be transported to a new location, so they're generally treated like mobile homes and are harder to finance.

Gary's Advice: If It Quacks Like a Duck…

Many investors make the mistake of taking the word of a seller or real estate broker that a house is a modular home when, in fact, it's a manufactured home. Here's one easy way to tell the difference: By law, a manufactured home must have a tag issued by the U.S. Department of Housing and Urban Development (HUD) on it. The manufactured tag is located in two places: on the outside of the home and under a sink in the kitchen.

As you're probably gathering from this chapter, we recommend keeping your investment business simple if you want to succeed. Stick to reasonably priced, single-family homes in good neighborhoods that you can buy at a discount because they need a little work. Keep the base of your investing portfolio in "the WOB in the MOB near the Blob" category. Once you've mastered this, you can move on to the more exotic investments.

Key Points to Remember

The most important concepts addressed in this chapter are:

- Invest in deals, not markets.
- Buy the WOB in the MOB near the Blob!
- Fixer-uppers can be a good bet—if you fix the right things.
- If you're a novice investor, avoid risky deals.

CHAPTER 6

Manage Your Cash Flow

"Cash is king."

—Anonymous

Ask anyone who has spent a long time in real estate (or any other business) about the secret to surviving and the response will probably be these two words: cash flow. To remain a successful investor over the long term, it's imperative to master the art of managing your cash flow, which is the sixth principle of defensive investing.

Many investors start out with little cash, and then what cash they do have, they often sink into one property. They go broke in the process because they don't understand the importance of managing their cash flow.

The Importance of Cash Flow

Many businesses fail in the first few year mainly due to poor cash flow management.

According to a recent survey, the number-one thing small business owners say they wish they'd have done differently was have more startup money. Even experienced companies file bankruptcy, not because they don't have a good business model but because they run out of cash.

Consumers, too, don't often manage their cash flow effectively and this can lead to foreclosures. True, the catalyst may have been an unexpected layoff, a change in the economy, a divorce, or some other crisis, but with sufficient cash reserves, consumers can overcome virtually any problem.

The same principle applies to any business. Something can go wrong or business can become slow because of a down cycle, but as long as the business manages its cash flow, it will survive. Real estate investing is no exception. The reason most investors fail is because their plans and investment strategies don't include effectively managing their cash flow.

For example, let's say an investor (we'll call him John) buys a house as a rental property investment with no money down. If John has no cash reserves, what happens if he experiences a 20 percent vacancy rate—that is, he doesn't rent the house for several months? What happens when there are repairs and unforeseen problems that may result in the need for thousands of dollars in repairs or improvements? John will have real problems if any of these events occur *if* his cash flow is low or nonexistent.

Bill's Advice: Unexpected Repairs May Blindside You—and Cause a Cash Crunch

Although I plan for repairs, vacancies, slow months, and a down market, I've had more than my share of unexpected cash crunch issues.

For example, several times a local municipality made me repave a driveway, remove an abandoned car, or rebuild a fence. My insurance company made me re-concrete a long walkway because of what they considered safety issues. More than a dozen plumbing problems have caused major water damage to my properties—damage that was less than my insurance deductible.

Every investor at some time gets blindsided by an unexpected repair cost, so be conservative when establishing your cash reserves.

In essence, real estate investors are no different from average Americans who struggle to get by and live paycheck to paycheck, then suddenly get hit with an unexpected medical bill or car repair expense. The bottom can fall out from underneath quickly, so you'd be wise to set up a financial safety net.

How Much Should You Keep in Reserve?

There's no magic formula you can use to determine how much you should keep in reserve in the real estate business. When we rent properties, the four key factors to consider are strength of the local rental market, eviction time line and cost, the age of the property, and the type of neighborhood.

Strength of the Local Rental Market

The lower the vacancy rates in your area, the fewer reserves you'll need for vacancies. Your local newspaper or your city's housing department may have articles or statistics on vacancy rates. You should, at a minimum, have enough cash reserves to pay for one month of vacancy per unit, which is only an 8 percent vacancy rate.

Even in a good market, you'll deal with problem tenants who may stop paying rent and require an eviction. Good tenant screening will help solve this problem. If you plan to rent properties, you should always, without exception, do a rigorous background check on tenants. This includes reviewing credit reports, employment verification, references, and calling current and previous landlords. (You'll find a list of resources for tenant screening in Appendix 4.)

Eviction Time Line and Cost

The length of time it takes to evict a tenant is relative to your cash reserves. In pro-tenant states like New York and Massachusetts, it could take months and thousands of dollars in legal fees to evict a tenant—all while you're paying the mortgage. In addition, in our experience, collecting back rents or damages from tenants who've been evicted can be futile.

Age of the Property

With newer and recently renovated properties, you won't need to anticipate many repairs in the first few years. As noted earlier, we recommend that you always hire a professional property inspector before you buy. Inspectors will go through the property with a fine-tooth comb, which helps ensure you'll have no surprises later on. Another thing to keep in mind is that many utility companies offer a fixed monthly payment option so you don't experience payment swings each season if you're paying for heating, water, or other utilities as the landlord.

Gary's Advice: Homebuyer's Warranty Is a Good Bet

When you buy rental property, purchase a homebuyer's warranty to cover everything from the furnace and air conditioner to appliances. These warranties are available from many reputable insurance companies and often cost less than $500 a year.

I know of an investor who buys properties in South Carolina and lives in California. He instructs his tenants to call a toll-free number when a repair that's covered by the insurance plan is required. I purchased a home warranty for approximately $300 and later discovered that the home needed a new furnace and hot water heater at a combined cost of nearly $2,400. Was the warranty a good investment? You bet!

Type of Neighborhood

If you're renting properties in low-income neighborhoods, you can expect the turnover to be much higher than in high-income areas. In addition, multiunit buildings with small units and one-bedroom condos will attract more single people who tend to move more often than families.

Cash Flow Applies to Fixer-Uppers and Flips Too!

Too often, inexperienced investors will buy houses, fix them up, and decide to sell them. At this point, the investors have all their money tied up in these houses. What happens if the houses on the market for six months? The investors embark on a downward spiral, which can lead to full-blown panic. Unfortunately, these investors can't blame anyone else for this situation; they should have planned for this possibility and had the foresight to accumulate enough cash reserves to get through this period. Lessons learned?

- Always price the property reasonably to move it quickly.
- Don't overspend on repairs.
- Plan for it to take twice as long to sell as the average property in the neighborhood.

Cash Flow versus Cash Reserve

Don't look at your cash flow in a vacuum but look at it in relationship with your overall financial strategy, the amount of cash you have available, and your return on investment. For example, if you buy rental houses for 100 percent cash, you probably won't have a negative cash flow, but you may not be maximizing leverage. On a similar note, the size of your down payment will affect your cash flow on rental properties.

The following examples can shed some light on cash flow versus cash reserve.

> **Cash flow example 1:** Purchase a $100,000 property with $20,000 down—Your $80,000 loan at 6 percent interest (including taxes and insurance) is about $600 a month. Assuming you can rent the property for $800 a month, you have $200 a month cash flow or $2,400 a year. The cash flow is good, but the $20,000 down payment may have wiped out your cash reserve.
>
> **Cash flow example 2:** Purchase a $100,000 property with no money down—Your $100,000 loan at 8 percent (this higher rate is common for zero-down loans) would make your payments close to $900 a month. Again, let's assume you can

rent the property for $800 a month. With zero down, you have $100 a month *negative* cash flow—but you still have the $20,000 in reserve.

Which is better? Well, it depends on your goals and the rest of your financial picture.

Let's say you intend to hold the property for ten years. In the first example, you have $200 a month cash flow, but no cash reserve. In the second example, you have $100 a month negative cash flow, but you have $20,000 in reserve. Some people automatically assume that the first example is safer, but is it really?

Think about it this way: In the first example, if your property becomes vacant for one month, you'd be out of pocket $600. Once you rent the property, it would take three months to make up that $600. In the second example, you have $20,000 in a cash cushion to make up the deficit. With $20,000 in the bank, you could handle $1,200 a year negative cash flow for 16 years. If the property is in an appreciating market, you'd come out fine, even with negative cash flow.

Another factor in cash flow is the choice of loan. You could buy a property with nothing down and an interest-only loan fixed at 5 percent for three years. If your exit strategy was to sell within 36 months, then why select a fixed-rate loan for 30 years?

The point here is that you shouldn't automatically seek positive cash flow as the only goal when choosing financing. Likewise, you shouldn't buy properties just for leverage and/or appreciation with nothing down, experience a negative cash flow, and assume that short-term market appreciation will be the only source of your profit.

Do you see how cash flow and cash reserve are important considerations in your real estate investing plans and strategies? (See Appendix 5 for a sample form that records cash flow.)

How Cash Flow Affects Your Decisions

By now, you're getting the idea that to continue investing in real estate over the long term, you need cash reserves. Buying real estate with nothing down is easy. However, handling negative cash flow, repairs, and other expenses once you purchase the property is the real test. In fact, if you can make it through the bad times in real estate investing, you'll always come out on top. Lack of cash reserves—and the related fear of vacancies—puts unnecessary pressure on landlord-investors to do substandard repairs, accept unqualified tenants, and give in to tenants' demands. When these cash-strapped investors sell fix-and-flip properties, this situation forces them to drop the price and leave too much equity on the table because they can't wait for the property to sell to recoup their investment.

On the other hand, if you have the security of a sufficient cash reserve, you can act rationally and afford to play the waiting game, holding out for a higher sales price. You can also afford to wait for a qualified tenant and even leave properties vacant rather than renting to undesirable tenants. You can take care of necessary repairs and improvements on properties. In short, when you have cash in your pocket, it's a whole different ballgame than trying to operate with a lack of cash.

The bottom line: You can buy real estate without money, but you simply cannot survive in business without cash reserves. Thus, it's important to consider accumulating cash reserves before you invest in rental properties.

Generate Both Cash Flow and Cash Reserves

From a long-term perspective, rental properties can be a good source of steady cash flow and equity buildup. As an investor, you can buy a rental property and aim to break even, perhaps even provide some cash flow, but with repairs and vacancies, this can be an up-and-down process and most people won't be able to retire on rentals until these properties are paid off or have increased substantially in value. Therefore, you need to plan other ways to generate cash flow or cash reserves to protect your real estate investment business.

If you have a good-paying job, a spouse who works, another source of income, or other cash reserves, rentals can be a good long-term investment play. If you don't have any of these cash-generating "weapons" in your arsenal, consider the following popular options to generate some quick cash or build cash reserves.

Wholesale deals. A popular strategy is to do a lot of fix-and-flip deals to generate cash and build a cash reserve. However, inexperienced investors can get in over their heads quickly when a fixer-upper won't sell. Some cable television shows make it seem that rehabbing is easy, but it's a lot harder to make a buck than it looks. Investors who are new in the business, crunched for cash flow, or already involved in several fix-up projects may consider wholesaling deals to another investor.

The wholesale usually involves flipping a fixer-upper property "as is" to another investor who'll do the lion's share of the fixing. As the wholesaler, you'll only make a small profit ($5,000 to $10,000 per deal), but there's virtually no risk because, typically, you would accomplish the transaction by using a double-closing or contract assignment.

Basically, a double-closing (or simultaneous escrow) means holding two closings, back to back. The funds from the second closing are used to fund the first closing. The double-closing is an effective way to buy and flip properties without using your own funds. Despite rumors and urban myths to the contrary, there's nothing illegal about double-closings. However, many title companies and lenders won't do double-closings because they fear potential fraud, but this is generally more of an issue when flipping to owner-occupant buyers.

A contract assignment is an alternative transaction to a double-closing. Here, the buyer/investor assigns the purchase contract to another investor who closes in his or her place. In the case of a contract assignment, there's only one closing. A contract assignment is similar to endorsing a check to a third party.

Bill's Advice: Don't Be Greedy

When figuring your profit on a wholesale deal, don't expect too much. Many novice (and some experienced, albeit foolish) investors expect more profit than they deserve out of a deal. You must be realistic. If you want to sell a property quickly to another investor who'll do a lot of work and incur some risk, you can't expect to make as much as he or she will. While it's possible to negotiate a great price and make a strong profit, remember that most deals don't have enough room for two investors to "make a killing."

For a detailed discussion of the wholesaling process, refer to *Flipping Properties—Generate Instant Cash Profits in Real Estate*, 2nd Edition (Kaplan 2006).

Partner on Deals. If you don't have the cash reserves, consider partnering on a deal with someone who does. For example, a house in an expensive area may rent for less than the mortgage payments, even if you buy it at a tremendous discount in an appreciating market. Bringing in a partner to cover the down payment requirement and to feed the monthly negative cash flow could be profitable for both of you if you split the profits when you resell the property.

Make sure you verify that this partner actually has the money and consider forming a partnership or legal entity that has a bank account where the money is deposited. (Chapter 8 discusses legal entities in more detail.)

Bill's Advice: Half of Something Is Better Than All of Nothing

I know of a particular investor who had millions in equity. When the local rental market went sour, he was stuck on negative cash flow on hundreds of rental properties. His solution was to sell half of his equity, at a discount, for cash to a partner. He used that cash as a reserve to feed the negative cash flow the properties were demanding. As a result, he still has plenty of equity and plans to sell the properties when the local market rebounds in price.

The lesson he learned is a good one that many investors would be wise to follow: half of something is better than ALL of nothing is! If you can't handle negative cash flow, your equity won't matter much when you lose your properties to foreclosure.

Save Your Money. If your grandparents were like ours, they used to scrimp and save every penny they could. Consider doing the same and even wait awhile before investing until you have some cash in the bank. If you have a good-paying job, we suggest setting up an automatic debit of 10 percent or more of your income into a forced saving account.

Have Backup Sources of Funds. Having backup sources of funds for emergencies doesn't necessarily mean cash or other income. It can be (at least in part) access to credit cards and credit lines. Many businesses have access to lines of credit for emergency purposes.

Many banks offer business credit lines up to $200,000, but these are expensive to get. Often this will cost as much as $5,000, even if you don't use it. Don't fret, though; you may already have more available credit than you realize. Credit cards and other existing revolving debt accounts can be quite useful in real estate investing. Most major credit cards allow you to take cash advances or write checks to borrow on the account. The transaction fees and interest rates are fairly high, but you can access this money on 24 hours' notice. In addition, you won't have to pay loan costs that are normally associated with a real estate transaction such as title insurance, appraisals, pest inspections, surveys, and so on. Often, you're better off paying 18 percent interest or more on a credit line for six months than paying 8 percent interest on an institutional loan, which has up-front costs that would take you years to recoup.

Promotional interest rates are often available on your credit cards, but again, beware. These rates often skyrocket after several months. Chances are if you have a good credit history, you'll be able to raise your credit limits on your existing cards. Creditors don't need to know you'll be using your credit cards for the business of real estate investing. Ironically, these creditors would rather see you using credit-line increases for typical consumer purchases that depreciate in value and produce no income.

Keep in mind that you must approach high-interest debt cautiously. Your personality type may not embrace the idea of owing tens of thousands of dollars in revolving debt.

You can also benefit by using home improvement store cards with no cash advance features. These cards are available through the major lumberyards, hardware-store chains, and home-improvement stores.

They allow you to finance your material costs that can involve many thousands of dollars. The interest you pay for the use of this money is generally deductible, so be careful to separate your business credit card use from your personal credit card use.

A home equity line of credit (HELOC) can be an excellent financing tool if you use it properly. Basically, a HELOC is a credit card secured by a mortgage or deed of trust on your property. You only pay interest on the amount you borrow on the HELOC. If you don't use the line of credit, you don't have any monthly payments to make. You can access the HELOC by writing checks provided by the lender. Note that, in most cases, the HELOC will be a second lien on your property.

Key Points to Remember

Cash flow management is the bedrock of survival in any business, with real estate being no exception. Defensive investors must be careful not to run out of cash or they will be soon out of business.

The most important concepts addressed in this chapter are:

- Having little or no cash reserve is a surefire way to financial disaster.
- Lack of cash flow can cause investors to make foolish, risky decisions.
- Wholesaling properties can be a good way to generate cash flow.
- Line up sources of backup funds, such as credit cards and credit lines.

CHAPTER

7

Have Multiple Exit Strategies

"We must dare to think 'unthinkable' thoughts. We must learn to explore all the options and possibilities that confront us in a complex and rapidly changing world."

—J. William Fulbright

As mentioned earlier, we suggest you avoid entering a deal without having a clearly defined exit strategy. Walking into a deal blindly is a foolish move that will likely cost you dearly in the end. Many sorry investors have regretted jumping into deals without taking the time to think them all the way through to the finish line. For an investor to simply rely solely on Plan A is a risky approach. You must also have a Plan B and, ideally, a Plan C and D, as well. Our seventh defensive investing principle is having more than one exit strategy.

As discussed in earlier chapters, market timing is difficult to predict, and many investors get into a market too late. This is fine if you buy in areas where real estate appreciates over time and you actually stick it out for the long run. In the stock market, there's a concept called, "dollar cost averaging," which means if you keep buying consistently, you will make out long term because some of your purchases will be at the bottom of the market and some at the top. However, because the market will always go higher in the long run, all of your purchases will average out.

We believe the same concept applies to real estate—*if* you can survive in the long run. We don't suggest that you throw caution to the wind and just buy blindly. To the contrary, we advocate being defensive—that is, plan carefully, consider the risk, know your market before you buy, and have a backup plan if your assumptions turn out to be incorrect. In fact, defensive investors have several backup plans if the first one doesn't work out.

Choices, Choices, Choices

No single exit strategy is inherently better than any other is. The best choice for you in a given situation varies depending on numerous factors including your long-term plans, the local market, your cash-flow situation, and the condition of the property.

Let's discuss a variety of real estate investment strategies that could be your Plan A. Later in this chapter, we'll discuss appropriate backup plans you can turn to when Plan A doesn't work.

The Fix-and-Flip

In the rehab deal, an investor intends to buy a property in need of repair, fix it up, and then sell it to an owner-occupant. This property will likely be listed on the Multiple Listing Service and involve a real estate agent. Investors call this selling *retail*.

Always figure on paying a real estate commission when you sell property retail. The standard commission in most parts of the country is about 6 percent. Many novices make the mistake of thinking they can cut out the broker's commission and sell property on their own. However, more than 95 percent of all retail properties (new homes excluded) sell on the MLS so don't assume you can beat the odds.

The Wholesale Flip

As you learned in the previous chapter, you can flip a rehab property "as is" to another investor. With this exit strategy, keep in mind that there must be enough profit to go around here. Don't try to work

Bill's Advice: Consider Using a Flat-Fee Listing Broker

If you have extra time on your hands, you can go with a flat-fee listing broker. Most properties involve two brokers: the listing broker and the selling broker (a.k.a. the *buyer's broker*) who split the commission when the property sells. For a $200,000 house, a 6 percent commission is $12,000. A flat-fee listing broker will charge you $500 or less to list the property on the MLS. You'll still need to pay the selling broker's commission (about $6,000 in this example), but you'll save a lot of money—about $5,500 in this example. However, you'll have to conduct your own open houses, show the property, and prepare contracts yourself. If you're uncomfortable with the paperwork and legal details, hiring a good real estate attorney is a lot cheaper than a listing broker!

on the "greater fool" theory—that is, a novice investor who knows less than you, buys it thinking he can make a profit. This is hardly a way to make a living, is unpredictable, and will not leave you feeling good about yourself at the end of the day.

The Partial Rehab

In strong markets, you can flip properties directly to the retail sector with little or no rehab work involved. This an excellent exit strategy in strong markets because if the property is in decent shape, you may only need to do basic redecorating to prepare it for resale.

Even when the property needs more work, you can often make essential improvements quickly and then sell it as a minor fixer-upper. This is often referred to as a *partial rehab* or a *flip/fix combo*. In this situation, a thorough cleaning and some painting may be sufficient to get this property ready for sale. You can complete those tasks within a few days so you'll be able to offer this type of property for sale quickly.

The Rental

You can buy and hold a property as a rental, or you can buy, fix, and hold a property as a rental. With this strategy, you must be familiar with the rental market in your area (particularly in your farm area), the appropriate expenses, and the rental laws. Keep in mind that rentals require time management so you should be able to devote the appropriate time. Hiring a property manager for one single-family home is economically unfeasible and usually unnecessary. Property management isn't easy and you should learn how to do it properly. An old saying goes like this: "What you don't know about landlording, your tenants will teach you." We highly recommend these books:

- Goodwin, Daniel et al. *The Landlord's Handbook*, 3rd ed. Kaplan Publishing (2003).
- Robinson, Leigh. *Landlording: A Handymanual for Scrupulous Landlords and Landladies Who Do It Themselves*, 10th ed., Express Publishing (2006).
- Taylor, Jeffrey. *The Landlord's Kit: A Complete Set of Ready-to-Use Forms, Letters, and Notices to Increase Profits, Take Control, and Eliminate the Hassle*. Kaplan Publishing (2002).

The Lease/Option Strategy

Another popular exit strategy option is to rehab a property, refinance it, and then lease it to your renters using a lease with an option to buy. Lease/option is a popular format because it allows the seller to get top dollar for the property without paying a broker's fee while covering mortgage payments on the property until the tenant exercises his option to purchase. Generally speaking, you can get a higher price for a property if you offer creative terms (e.g., give a partial rent credit to tenants against the purchase price of the property, which allows them to generate equity if they can't afford a down payment at the time). If tenants do exercise their option to purchase after 12 months, you'll fare better with your tax situation than if you had flipped the property quickly.

Bill's Advice: Take Time to Learn the Pros and Cons of the Lease/Option Strategy

If you hold a property for 12 months or more, the gain on the sale is considered a long-term capital gain and taxed at a lower rate than if you sell the property within 12 months. (We'll discuss taxes in more detail in Chapter 8.)

However, a lease/option transaction does involve inherent risk. If tenants choose not to exercise their option to buy, you're left with the property. The market may have taken a downswing since you first obtained the property, meaning you'll either need to lower your asking price or hold on to the property awhile. In addition, if tenants put down a substantial deposit or did repairs and improvements, they may be able to claim an "equitable interest" in the property, making eviction more difficult. Good paperwork is essential to making any lease/option strategy go smoothly. For more details, check out the "Big Profits with Lease/Options" system, which is available at **www.legalwiz.com**.

Owner Financing

As the investor and seller in an owner-financed sale, you'd take all or part of the purchase price in the installment payments after closing instead of taking all cash. Remember, "all cash" doesn't necessarily mean the buyer is using 100 percent cash to purchase the property; it may mean the buyer gets a loan. Both result in the seller receiving all cash for the purchase price.

Three top benefits of doing an owner-carry installment sale rather than a cash sale are:

1. **Highest price**—As the seller, you can insist on and receive the highest price when offering flexible owner-finance terms. In many cases, you can receive more than the fair market value of the property by offering these "soft" terms. People are always willing to pay a premium for nonqualifying financing.

2. **Cash**—Nearly every seller says he or she wants all cash, but few really need it. Instead, the typical seller wants the most *net* cash from the deal. Often, the seller must pay closing costs, title insurance, broker fees, and the balance of the existing financing. In addition, you may need to pay capital gains tax to Uncle Sam. In many cases, the sale of a property by an installment sale will net you more future yield than any source from which the cash proceeds were reinvested.
3. **Fast closing**—Nothing holds up a sale more than new lender financing. In some areas of the country, it can take months for a buyer to qualify and close a new loan to purchase your property. Because most standard real estate contracts contain a financing contingency, you may end up back at square one if your buyer doesn't qualify for a loan.

There are few assumable loans available to buyers and few sellers offer these soft terms. Thus, an owner-carry sale makes your house unique. Furthermore, an owner-carry transaction can be consummated in a matter of days. That's because there is no appraisal, underwriting, or survey involved. In many cases, you'll be able to sell the property with owner financing and save thousands of dollars in real estate brokers' fees.

Pitfalls and risks of owner financing. The main risk of offering owner financing is that the buyer may default, requiring you to go through a legal proceeding to get the property back. An unrecorded land sale contract (a.k.a. "contract for deed") is often a viable strategy to allow you to sell the property and quickly remove the buyer for nonpayment. It can be challenging, though, because the process is not well defined in many states, resulting in uncertainty as to the legal process and thus the cost and time involved.

A foreclosure on an owner-financed deal may take several months and cost many thousands in legal fees; all the while, you're paying your existing loan payments, property taxes, and so on. It's important to discuss the process with a local attorney before proceeding with an owner-financing sale.

Exit Strategies and Financing Options

As a real estate investor, your exit strategy will play a major role in deciding the kind of financing option you may need or want. The main factor will be your anticipated time from loan initiation to loan payoff.

Short-Term Financing

Short-term financing is a temporary source of money that you may use, assuming you'll refinance or resell the property quickly. Short-term financing generally has a higher rate of interest and a balloon or payoff deadline within six to 12 months. Generally, you access short-term financing through smaller commercial banks or private hard-money lenders (called equity lenders) who make their money on up-front points and fees.

Short-term financing is useful even when long-term financing may be a better deal for two reasons: availability and speed.

Availability of financing is often more important than cost. Although short-term loans are often costly, even a high-interest loan can make sense when you plan to keep the property for a short time before selling or refinancing it. This does involve some risk, though—if something unexpected happens and you can't sell or refinance the property quickly, you'll be forced to endure that high interest rate.

You can quickly obtain funds with short-term financing. Generally, long-term financing takes more time and requires more documentation, which potentially means a lost opportunity for a good deal. With short-term financing, equity lenders are more concerned with the collateral they are lending against than the credit or income of the borrower so funding can be completed in a matter of days. Availability of quick financing can be important to your real estate investing business because decisions are made by a smaller, more flexible lender who will finance deals that the big players won't.

While equity lenders won't go as high on loan-to-value as the credit-based lenders, they base their loan-to-value calculation on whichever is highest: the purchase price or appraisal. Remember, credit lenders generally base their loans as a percentage of whichever is less: the purchase price or the appraisal price. This means that even if you purchase a property at 50 percent of value, you can't do this type of loan with no money down.

Bill's Advice: Buy "Subject to" Existing Financing

If possible, try to buy the property "subject to" the existing financing as an alternative to short-term financing. Buying "subject to" means you get the seller simply to deed you the property without paying off the existing loan. As the buyer and investor, you would make the payments until you sell or refinance the property. Buying "subject to" existing financing is fast, less costly (no new loan costs are involved), and doesn't tie up your credit.

In most cases, the mortgage or deed of trust securing the existing loan contains a due-on-sale restriction, allowing the lender to call the balance owed immediately due and payable. Some misinformed real estate "professionals" will tell you that it's illegal to transfer ownership of a property without notifying the lender. This is hogwash. First of all, most lenders could care less, especially if the payments are being made on time. Second, by the time they find out, you'll have paid off the loan by reselling the property or refinancing the debt. It's a good idea, however, to make sure there is full disclosure in writing to the seller about the implications of leaving the loan in his or her name. Some states have a mandated disclosure for taking "subject to" properties in foreclosure.

Keep in mind also that if you sell a property by a lease/option or land sale contract (a.k.a. "contract for deed"), it will also trigger the due-on-sale process on your underlying loan. However, most lenders don't find out because the agreement is not recorded. In most cases, lenders don't even care as long as the loan is being paid; their only incentive to enforce the due-on-sale is financial. If market interest rates are higher than the existing loan, it makes sense for the lender to make you pay it off so they can refinance you (or your buyer) at a higher rate. Therefore, it's recommended that you place some sort of "out" position (e.g., a balloon date or option expiration date) so you aren't tied to the deal indefinitely and risk the lender calling in the loan.

Long-Term Financing

Long-term financing will give you more options if you're not pressed for time to close, when loan-to-value isn't an issue or you plan to keep the property as a rental. Many options for long-term financing are available if you have good credit. These include fixed-rate, adjustable-rate, and interest-only payment loans, and the option adjustable rate mortgage (ARM).

In a rising interest rate market, fixed-rate loans may be the way to go if you plan to keep a property for a long time. However, a 30-year fixed-rate loan is generally the most expensive type of long-term loan in terms of fees and interest rates. Adjustable-rate and interest-only payment loans can be a cheaper option, depending on your back-end strategy. Generally speaking, a loan that adjusts based on the market rate of interest charged is less risky for lenders because it hedges their bets against rising interest rates. Accordingly, they'll offer you a cheaper starting rate than if the rate were fixed over 30 years.

Of course, the same risk works *against* you if interest rates rise in the future. Many adjustable rate loans are fixed for a certain time period (e.g., three years) and/or can only adjust a certain percentage per year. You don't want any big surprises. If you plan to sell the property on a lease/option within a few years, then an adjustable rate mortgage may be the way to go.

One of the most misunderstood loans is the called the option ARM. With an ARM, the interest rate is based on an index like the London Interbank Offered Rate (LIBOR). The loan has four payment options, each of which can change monthly based on the interest rate the loan is indexed to.

These options are:

- Interest only
- Amortized for 15 years
- Amortized for 30 years
- Minimum payment

Depending on the market interest rate, the minimum payment may create a negative amortization, which means the loan balance may increase with time. Carefully used, an option ARM can be an excellent way to hedge your bets with rental properties because this provides a low-payment option if you have unexpected repairs or vacancies. The ARM is particularly effective in a rising price market because it gives you some breathing room if your loan balance is increasing.

Prepayment Penalties

Carefully check when you get a loan to see if there's a prepayment penalty. Often, loan reps quote you a better rate than their competitors; you find out why when you go to sell the property and discover that there's a prepayment penalty. A prepayment penalty is a fee you must pay to the lender for paying off the loan early. In most cases, the penalty only applies in the first few years of the loan. A prepayment penalty is typically three to six months of interest payments based on the original amount of the loan.

Prepayment penalties are not always a bad thing. If you have no intention of selling or refinancing the loan within the first few years, then having a prepayment penalty won't be a problem. In fact, it may allow you to pay less in loan fees or have a lower interest rate. If you're uncertain of your exit strategy and want the most options, you may have to pay a fee up front to get rid of the prepayment penalty.

Gary's Advice:
Don't Be Tricked!

Two types of prepayment penalties exist: "hard" and "soft." The soft prepayment penalty applies whenever you refinance the property and don't sell it. A hard prepayment penalty is paid for the term of the penalty, whether you transfer title in any manner or refinance it. No matter what your mortgage broker says, read the documents carefully at closing. Many investors get tricked into signing documents with a prepayment penalty. When they realize the mistake, it's often too late, so beware!

Remember, the lending business changes often, and this can affect your exit strategy if you had planned to refinance the property a few years down the road. You need to work with a knowledgeable mortgage professional before you go into a deal.

What to Do When Plan A Doesn't Work

When your primary plan of action doesn't work, you need to have a backup strategy. This may involve switching gears from a retail sale to a rental or rent-to-own deal. However, before you give up, here are a few tricks that may work and a variety of backup strategies.

Stage It

The cheapest way to create appeal for your property is to stage it—that is, dress it up so it doesn't look empty. The idea is to upgrade the appearance of the property, so you wouldn't use cheap-looking items or those that might appear too personal in taste. You may feel qualified to make all the decisions regarding your décor and presentation, but it would be wise to get second opinions from an interior decorator, friend, or real estate expert. Visit show homes in new neighborhoods to gather ideas. You can even borrow a few items from your home if you don't have sentimental attachment to them.

Professional staging companies will decorate the house and bring the furniture with them. Depending on the size of the house and price range, this may make sense. It isn't uncommon for sellers to pay $10,000 to decorate a $1,000,000 home professionally. Of course, this may be overkill in a small starter home or condominium priced under $250,000. Although the term *home staging* is trademarked, it has become a common expression in the industry and refers to the process of decorating houses for resale.

Visit these Web sites to learn about easy ways to stage your properties for sale:

- **www.simpleappeal.com**
- **www.stagedhomes.com**
- **www.homestagers.com**

Offer Attractive Sales Terms

Every type of business acknowledges the value of offering attractive financing terms to attract customers—especially in cases involving a backlog of inventory that needs to be sold. Auto dealers frequently employ this strategy, especially at the end of the year when they need to clear out last year's models to make room for the coming year's models. This is when you'll see commercials promising "zero-percent financing" deals or similar offers.

It's no different in real estate. Investors who have properties that haven't been selling can often increase a buyer's interest by offering attractive financing options. For example, you can offer to pay the closing costs or you can "buy down" the buyer's interest rate by offering to prepay six months of payments on the buyer's loan. Another strategy is to offer to carry back 10 percent or more of the purchase price with a note secured by a lien on the property. By making arrangements in advance to help buyers with financing, you can attract more buyers.

Bill's Advice: Don't Cross the Line from "Creative" to "Criminal"

Whatever creative financing you do, make sure it's aboveboard and disclosed on the settlement statement (HUD-1 form) at closing. Sometimes sellers (at the suggestion of the buyer, the buyer's real estate broker, or mortgage broker) mark up the sales price and give the seller his or her down payment back after closing. In this way, the buyer can get 100 percent financing. This is illegal—don't do it.

Change Your Exit Plan

Your exit strategy may have been to sell the property retail, but if that doesn't work out, you could refinance and rent the property awhile. On the other hand, you could offer a lease/option or owner financing. You might also consider the advantages of wholesaling to other investors, not only for cash but also for alternative terms.

Bill's Advice: It Pays to Be Flexible

I once put a rehab property under contract and tried to flip it wholesale, only to find out there was a slim profit margin for a fix-and-flip. The investor who bought it from me gave me a note, which was paid when he resold the property. The total cash in my pocket wasn't substantial, but I only spent a few hours on the deal. Sometimes it pays to be flexible and receive your profits on a marginal deal, which is better than losing a deal altogether.

Bring in a Partner

Sometimes a partner can bring something to the table that you don't have. The missing resource could be credit (the ability to borrow to refinance the debt), cash, or experience. Bringing in a partner to rework the deal can be effective, particularly if there's enough equity to share. For example, if your credit is shaky, you're overextended, or you simply ran out of cash, a partner can help fund negative cash flow or lend his or her credit to refinance the property in exchange for a percentage of the back-end profit. Remember, there must be enough equity in the deal for a second person to profit; otherwise you won't find too many willing partners.

Bail Out and Cut Your Losses

Sometimes the only option is to bail out and cut your losses. It takes a big person to look in the mirror and say, "I made a mistake." Too many investors let their egos get in the way and hold on longer than they should and the bleeding never stops. If it's a retail deal, then drop your price, even if it means losing money. If it's a rental, drop your rent low enough to attract a solid tenant. If your monthly carrying cost is

$1,000 on a unit, it makes sense to drop your rent by $80 a month rather than have a vacancy. In fact, if you're offering the property on a lease with the option to purchase, you may consider dropping the rent below market and taking a monthly loss to make it up on the back end, assuming there's enough equity to justify the monthly loss.

For example, suppose you buy a house for $150,000 and it's worth $200,000, but because of a poor financing choice, your monthly payment is $1,300 a month. Even if market rents are $1,100 a month, that doesn't mean you must hold out for $1,300 a month. Rather, it makes sense to rent it for $1,100 or even $1,000 to get a qualified tenant who can eventually buy it for $200,000 in two years. A loss of $300 for 24 months is only $6,800, which is justified when you make $50,000 profit on the back end. Words of caution, though, never compromise your rental standards because it will cost you more in the long run for evictions and repairs.

Over the past few years, many novice investors got into preconstruction deals, anticipating a huge increase in prices by the time the development finished. Instead, the values flattened or dropped. Rather than walk away from their deposits, many insisted on completing their purchases, hoping the market would come back. They were often wrong, and ended up selling the property for less than they bought it for. If they had stayed in the game long term or had devised a viable alternative exit strategy (such as renting in the meantime) then they may have come out on top. More often than not, however, the best course of action may be to cut your losses early.

Real-Life Story: Sometimes Cutting Your Losses Is Best

An investor we know put up over $100,000 in deposits on new construction condos in Las Vegas. By the time the first half of the development was half built, "reservation" prices on the second preconstruction phase were higher than the first phase prices. The investor figured that the difference between the so-called "market" prices of reservations on the second phase and the prices he had reserved in the first phase amounted to about $500,000 in equity.

We tried to explain to him that this equity was like fool's gold because neither phase of the construction was complete and by the time he'd actually resell those units, the true market price could be lower than his acquisition price due to competition from other condo projects.

When the time came for the next required payment on the condo units (over $250,000), we suggested he either sell one-half of his interest in his "equity" to a partner for $100,000 (limiting his risk to zero) or walk way. He was incredulous, insisting that he had $500,000 in equity. Unfortunately, many novice investors don't think defensively when it comes to real estate. Time will tell who's right on this deal, but there's a lesson to be learned. As the old expression goes, "pigs get fat, hogs get slaughtered."

Renegotiate the Debt

If you end up owing more on a property than it's worth (or on several properties for that matter); you could be in a real pickle. There's no room to drop your prices if the market value of your houses is less than your debt.

In this case, you can either wait out the market or negotiate with the lenders who hold the liens on your properties. Your likely options are short sale, forbearance, and deed in lieu, discussed next.

Lenders realize that taking back properties in mass isn't good for their portfolios. Often, they're willing to take a discount on what is owed. Called a *short sale*, the lender essentially accepts less than the full amount as a payoff, contemporaneously with a sale. The lender won't allow you to profit from the deal so a refinance isn't possible; you need to sell the property to a buyer at an arms'-length transaction (that is, to someone who's not related to you by family, friendship, or business). Make sure the debt is settled in "full satisfaction"; otherwise, the lender could sue you for a deficiency. Keep in mind, also, the extent that the debt is forgiven by the lender because you may have taxable income. We strongly suggest reviewing this exit strategy with your tax advisor before proceeding.

If all you need is more time to try to sell a property, sometimes you can work a forbearance with the lender. A forbearance happens when the lender agrees to work with you on back payments. If you have the property actively listed, the lender may delay proceeding with foreclosure on the property, which gives you more time to sell it. Remember, the more contact you have with your lender, the more the lender will be willing to work with you. Silence is the worst tactic when you're in default on a loan with your lender.

If the lender is willing, another option is to accept a deed in lieu of foreclosing the property. This involves simply deeding the property to the lender in exchange for the lender's promise not to sue you for a deficiency.

Buy It Right

As stressed earlier, *you need to make your money when you buy*. Thus, you can see how your exit strategy is often dictated by two factors: your purchase price and your local market. The better deal you get when you buy, the more options you'll have on your exit. Too many investors make the colossal mistake of paying too much for a property and assuming they'll "make it up" on the back end of the deal.

The following common mistakes shed light on how investors can fail to "buy it right."

The "Skinny" Rehab

Let's say your rehab strategy is to buy at 75 percent of the after-repaired value, less repair costs. The property is worth $200,000 in perfect condition and needs $20,000 in repairs. The maximum you want to pay is 75 percent of $200,000 ($150,000) minus $20,000, which equals $130,000. You offer $130,000 and the seller counters at $150,000. You arrive at a negotiated price of $143,000. It's more than you wanted to pay so you figure you'll spend a little extra in repairs to make it extra nice so you can sell the property for $205,000. However, when you get into the project, you realize it will cost $30,000 in repairs. Then you'd have to list it for $209,000—without a single comp in the neighborhood to support that price. You end up holding the property too long, dropping the price, and selling the property for $193,000. After loan costs, holding costs, seller concessions, and real estate broker commissions, you barely break even. This is a common tale.

The moral of this story is that you have to be conservative in your repair estimates and your resale price on rehabs. There's rarely such a thing as a "skinny" rehab unless you are keeping it as a rental or are lucky enough to be in a hot market where properties sell no matter what their condition.

The "Skinny" Lease/Option

You buy a property worth $200,000 for $180,000. It only needs carpet and paint, or so you think. Your strategy is to sell it on lease/option for $209,000. Once you fork over $4,000 in loan costs to acquire the property, you realize the small "carpet and paint" job also involves replacing a furnace and hot water heater, totaling $8,000. The property sits vacant for two months while you look for a tenant. This brings your total acquisition cost to $200,000. To top it off, your tenant/buyer leaves after three months. Your property is once again vacant and you're losing money.

The moral of the story is that you shouldn't pay top dollar for a property just because you have a built-in back end, because that back end may not work. Instead, develop multiple exit strategies in case your initial plan doesn't work out. Certainly you'll save a few bucks by not having to advertise for a tenant and pay monthly mortgage payments in the meantime, but that doesn't justify paying $20,000 more than you should.

The "Greater Fool" Deal

You're trying to wholesale fixer-upper properties to other investors without a clue about what other investors want to pay. You get a $200,000 fixer-upper property under contract for $166,000, then attempt to find someone who'll buy it from you. Three investors tell you that you're asking too much. On top of that, you want $10,000 to assign the contract. You figure you'll advertise it in the paper and flip it to a novice investor. Once in a while, you can justify it by saying, "Well, that person is just less discriminating than I am." The point here is you need to have ethics in this business; taking advantage of others should not be a basis for your investing practices.

We see these mistakes every single day in our business; they're all too common. The bottom line is that you need to obtain a property that's cheap enough to leave yourself multiple exit strategies. If you buy a cheap enough property but it won't sell, drop the price. If it won't rent, you'll have enough room to sell it cheap—and the more equity you have, it's easier to bring in a partner or refinance the property.

Gary's Advice: Shoot for 20 Percent Equity

The magic number for investor financing is *80 percent*. As long as you have a bona fide 20 percent equity position (or better), financing is generally fairly easy. Once you try to go higher than 80 percent loan-to-value financing, your options are limited.

Key Points to Remember

The defensive investor is always thinking "exit strategy." Better yet is having a backup plan, making you a really smart investor. The name of the game is "risk" and the more contingencies you plan for, the better your chance of success.

The most important concepts addressed in this chapter are:

- Never get into a transaction without having a plan to get out of it.
- Having one exit strategy isn't enough. You also need to have a Plan B as a backup.
- Sometimes your only option is to cut and run.
- Buy right and you'll have multiple exit strategies.

CHAPTER

8

You've Earned It, Now Learn How to Keep It

"A lawyer with his briefcase can steal more than a hundred men with guns."

—Mario Puzo, author of *The Godfather*

Unfortunately, we live in a litigious society where many people seek to place blame on others. Some people believe that if you treat people right and carry sufficient insurance, you'll be fine, but that's naïve thinking, which can get you into a lot of trouble. One lawsuit can ruin everything you've worked hard to create, which is why it's critical to apply the eighth principle, learning how to keep your wealth.

Real estate is a high-risk business, particularly when dealing with rental properties, tenants, and rehab projects. There are a lot of ways to mess up a deal and lose your investment—and potentially more if someone has a good lawyer. Every investor needs to learn some defensive strategies to keep what they have, including limiting taxes and avoiding lawsuits.

Know the Laws

Start by knowing the laws as they apply to your real estate business. The old expression "ignorance of the law is no defense" is true. You're expected to know the law as it applies to your business. Your state, city, or municipality may have particular laws, codes, and regulations with which you must become familiar. Discuss your business practices regularly with a local attorney and other investors in your business. Review your forms, agreements, and contracts to make sure the disclosures and clauses are appropriate for the particular way you do business.

Common Investor Legal Mistakes

You can't expect to reduce your risk of getting sued to zero, but you can take steps to reduce your risk as much as possible. In any situation where your money is at risk, ask yourself, "Is there a better way?" Know the legal and financial risks of the situations in which you place yourself, your business, your family, and your assets.

Without covering every issue involved, here are a few common mistakes that investors make, novice and experienced alike.

Poor legal forms. It's amazing how short-sighted novice investors can be when it comes to shelling out money for good legal contracts. They often buy contracts at discount office supply stores, from Internet Web sites, or borrow them from friends. However, a real estate deal is only worth the paper it's written on. Like the old expression, "every tax strategy works until you get audited," it can be said that "every contract works until you have a dispute." Therefore, invest in a good set of legal forms that apply to your practice and ask a local real estate attorney to review them. Also, make certain you fill in the forms correctly—a good real estate attorney will review contracts for just a few hundred dollars.

Too many people rely on real estate brokers to fill out contracts, which is fine for a "standard" deal. However, most brokers aren't trained in legal matters and often create long contract addendums that are insufficient to protect your interests.

Illegal discrimination. The Fair Housing Act of 1968, as amended, prohibits discrimination on the basis of race, color, religion, nationality, familial status, age, and gender. Many state and local laws also forbid discrimination on the basis of sexuality or source of income and the Americans with Disabilities Act makes it illegal to discriminate against disabled people. If you harbor any such prejudices and would allow them to come into play when renting a housing unit, then you're probably not cut out to be a landlord. However, many sincere real estate investors make honest mistakes that result in discrimination lawsuits. The best way to avoid these lawsuits is to be informed.

The Fair Housing Act may appear to be common sense and most people would never think of discriminating against people of different races or religions or on the basis of gender. However, it's important to note that the Act extends beyond the screening process and into advertising as well, so watch the wording in your ads. This is where many landlords and property managers make critical mistakes. Some people scour the classifieds looking for inappropriately worded ads so they can pounce on them and threaten a lawsuit. While someone must have standing to bring suit, these scoundrels often work in coalitions to ensure that all of their bases are covered.

For example, if you own a rental property in a predominantly Jewish community, its proximity to the local synagogue could be a major feature. However, if your ad says "within walking distance of the synagogue," you could be sending the message "Gentiles need not apply"—even though this wasn't your intent. Keep in mind also that you may not discriminate on the basis of whether a couple is married and whether children are to live in the unit. You may also not discriminate on the basis of age. Often, novice landlords aren't aware of these areas of concern—and while it's good that citizens are more aware of their rights today, it can create a bad situation for well-meaning landlords who are out of step with the law.

Be aware of your local laws and use good business sense. State law and local ordinances can extend similar protections granted under the Fair Housing Act to other groups. For example, California, Minnesota, and North Dakota prohibit discrimination based on source of income. In other words, landlords can't discriminate against would-be tenants who rely on public assistance. Putting the political perspective of the landlord aside, such discrimination makes little business sense because people on welfare or social security are virtually assured of a fixed income.

The Americans with Disabilities Act (ADA) prohibits discrimination against the disabled and also requires landlords to make "reasonable accommodations" to disabled tenants. Who decides what's reasonable? Typically, courts, if it comes to that; but while most landlords are aware of the ADA and would never stoop to discriminate against a person in a wheelchair. However, many are unaware that the ADA also protects mentally disabled tenants. A mental disability could also include recovering alcoholics and drug addicts.

Improper disclosures. Improper disclosures are a common mistake for investors. It's critical to be aware of the federal and state requirements for disclosures. For example, federal law requires a lead-based paint disclosure on the sale or rental of properties that were built before 1978. State laws may have additional regulations.

It's become common practice for real estate brokers to use a property disclosure form for all aspects of the house. Even if you're selling your house on your own, be sure to use one of these forms (refer to the sample in Appendix 6). Whenever in doubt, disclose what you know, especially something the buyer or tenant may not know about, such as dangerous conditions, water damage, electrical issues, or plumbing problems.

Illegal solicitation of money. Many novice investors try to solicit money for investing via public advertising or mailings. This is commonly referred to as *syndication*. You may inadvertently cross over a variety of federal and state securities regulations when trying to raise capital. Chatting with friends over the dinner table about a real estate deal is one thing, but advertising to the public in mass may be considered a "public offering". Before soliciting money from strangers, review your marketing, paperwork, and solicitation strategies with a local attorney well versed in this area of law. You may be able to get away with a good set of written disclosures if you solicit money on a limited basis, but it's better to be safe than sorry.

Independent contractor liability. The IRS and your state department of labor are on the lookout for employers who don't collect and pay withholding taxes, unemployment, and workers' compensation insurance. If you have employees that are "off the books," you're looking for trouble. If you get caught, you'll have to pay withholding taxes and as much as a 25 percent penalty. Intentionally failing to file W-2 forms will subject you to a $100 fine per form.

If you hire people to do contract work for you on a per-diem basis, the IRS may consider them employees. If any workers fail to pay their estimated taxes, you may still be liable for withholding.

To protect yourself, you should:

- Hire only contract workers who own their own corporation or get the business card and letterhead of any unincorporated contractors you may use so you can prove these workers aren't your employees.
- Require proof of insurance (liability, unemployment, and workers' compensation) in writing.
- Get written contracts or estimates on workers' letterhead that states they'll work their own hours and that you don't have direct supervision over the details of the work. (Refer to the sample independent contractor agreement in Appendix 7.)
- Have letters of reference from other people for whom the contractors worked to show that the contractors didn't work solely for you. Keep these in your files.
- File IRS Form 1099 for every unincorporated worker to whom you pay more than $600 per year.

In addition to possible tax implications, an independent contractor can create liability for you if a court determines the contractor is your employee. For example, if your independent contractor is negligent and injures another person, the injured party can sue you directly. If facts show that you exercised enough control over your contractor, a court may rule that this contractor is your employee for liability purposes. As you may know, an employer is "vicariously liable" for the acts of his or her employees—the employer is liable as a matter of law without proof of fault on the part of the employer. Make certain you follow these guidelines when hiring contractors and pay particular attention to the issue of control.

Finally, under your state's law be aware which duties are considered inherently dangerous, such as providing adequate security for tenants in a multiunit building. These duties can't be delegated to an independent contractor without liability on your part, regardless of whether the person you hire is considered an independent contractor or an employee.

Insurance—Your First Line of Defense

We suggest you insure each property you buy with plenty of liability coverage. Most investors don't specifically ask for liability coverage so they get a standard policy that may have adequate replacement coverage but minimal liability coverage. We recommend you get $1,000,000 in liability coverage for each property, even if it's a cheap property. Investors often fall into the trap of thinking, "Gee, it's just a cheap little condo," when, in fact, an injury can result in the same liability as an expensive property.

You may even consider a "builder's risk" policy if you do a lot of rehab projects. If you're concerned about cost, get insurance with a large liability portion and a high deductible. If you carry your property liability, personal residence, and business insurance with a single carrier, they will offer you an umbrella policy for several million dollars of additional coverage at a reasonable price. Be aware that certain claims—such as breach of contract, discrimination, and misrepresentation—aren't covered by insurance. In fact, most insurance won't cover any intentional act. Therefore, while having insurance is a good thing, it's only your first line of defense to lawsuits.

Corporate Entities—Your Second Line of Defense

You can know the laws and carry lots of insurance, but if you do enough business, you'll end up with a lawsuit that won't be covered by insurance. Setting up a corporation or LLC creates a barrier of protection from liability.

Avoid Being a Sole Proprietor

Most people starting their own businesses do so as sole proprietors. This means they are doing business as individuals or under fictitious "Doing Business As" (DBA) names. This scenario offers absolutely no liability protection. If your business gets sued, all your personal assets are at risk as a sole proprietor—your home, savings accounts, cars, and more. If you're the buyer or seller on a real estate contract, you (not your fictitious DBA) will be sued in the case of a breach of contract. If you sign a warranty deed as seller and any problems with title arise, you can be sued personally for breach of warranty, even if you paid for title insurance. If workers are injured on your property while you're rehabbing it, say hello to their lawyer. The fact is, there are dozens of scenarios that can lead to liability, and you're fully exposed when you conduct a real estate investment business in your own name.

The best way to protect yourself is to avoid getting sued personally—that is, form a legal entity to wedge between yourself and the liabilities that your business creates.

Set Up a Corporation or LLC

For less than $100 in most states, you can form a corporation or limited liability company (LLC) to do your business or trade. If properly maintained, a corporation or LLC will shield your personal assets if your business gets sued or goes bankrupt. A corporation can also provide you with some tax benefits, if used properly. Furthermore, a corporation or LLC gives you a more professional look when dealing with people in business. A corporation can be formed with a single owner, as can an LLC.

Some people may think that incorporating your business to limit your financial exposure is somehow unethical. Others think lawsuits are the equivalent of legal extortion. How you want to limit your liability is a call you'll have to make, but if you do incorporate your business, you'll have greater protection.

Bill's Advice: Know the Difference Between an LLC and a Corporation

Both a corporation and an LLC are formed under state law by filing papers with your state department of corporations or secretary of state. Both limit the liability of their owners, but these entities are taxed differently. You should discuss appropriate tax issues with your CPA or tax advisor before proceeding. For example, a C corporation, if used properly, can save you tens of thousands of dollars in taxes if you know how to use it. Most people believe a C corporation is bad because of double taxation. While this is true, an S corporation or LLC isn't necessarily better than a C corporation. For example, a C corporation can give you the ability to deduct 100 percent of your medical expenses and medical insurance through your company. You may also save thousands of dollars in federal income taxes if you learn how to "split" your income between your corporation and your personal return or other entities.

For more information on C corporations and how they can work for you, you can order "How to Create a Bulletproof Corporation" program from www.legalwiz.com.

Gary's Advice: Another Benefit of Corporations and LLCs

There's a Catch-22 when starting out as a real estate investor. If you go to the bank for financing, the lender will require that you have two years of real estate investing experience. How do you get a loan to begin investing if you don't have investing experience? One of the first items of business is to set up a corporation or LLC that's registered with your state. After two years, lenders will recognize that you've been in business the required minimum time.

Doing Business with Partners

When it comes to liability, doing business with a partner can be even worse than doing business as a sole proprietor. A partnership is formed when two or more people decide to do business together for profit. It doesn't require a formal partnership agreement or filing of any official documents, although it's often formed that way. Moreover, you can create a partnership even if you didn't intend to! (We explain this in a following section.)

Here's the problem with partnerships: If your partner does something foolish, you're liable. If you allow your partner to commit the partnership to a contract, the partnership and its partners can be held liable for that debt. If your partner slanders someone, commits a negligent act, or incurs a debt on behalf of the partnership, you're on the hook—even if your partner files for bankruptcy. This is the doctrine of "joint and several liability." Regardless of the percentage of fault between you and your partners, a judgment by a creditor for any tortious acts is 100 percent collectible from any one of the partners. Joint and several liability can be particularly disastrous if you're the silent partner with all the money.

Another problem is the accidental partnership. Here's an example: Harry finds a good business deal. He needs capital so he approaches Fred. Fred agrees to invest with Harry as the silent partner. Harry deals with the public, often referring to his "partner" Fred. Fred and Harry do business, make money, and part ways. A month later, Harry gets into financial trouble. Creditors come knocking on his door, but he has no money to pay them, so these creditors come after his "partner" Fred. Is Fred liable? In some cases, the answer is yes if the public thought Harry and Fred were partners and Fred did nothing to stop Harry from presenting them as partners.

If you only want to do a one-shot deal with a partner, consider drafting a joint venture agreement. (Refer to the sample joint venture agreement in Appendix 8.) Basically, a joint venture is a partnership for a specific purpose. If you intend to do business with partners for the long term, consider forming a corporation or limited liability company.

Release Yourself from Liability

Legal disputes can often lead to lawsuits; smart investors stay out of court and away from expensive, risky lawsuits. However, most people forget one simple step that's crucial to the process of settling a dispute: a written release of liability. Omitting this simple step could result in a future lawsuit against you even if you settled the claim.

Consider an investor who settles with a tenant who was delinquent on his rent: the owner accepts the keys, waives the tenant's back rent, and allows him to move out quietly. Nevertheless, the tenant can come back and sue the owner at some point in the future, claiming damage to his furniture because of a leaky pipe.

In another example, an investor accepts an earnest money deposit on a real estate contract. However, the closing never happens and the investor keeps the earnest money. Believe it or not, the investor can be sued for breach of contract.

The secret to avoiding future liability on transactions such as these is shockingly simple: Get a written release of liability. This release, also known as a *general release*, is a simple document by which someone agrees to release someone else from all liability. A properly drafted release prevents the signor of the document (the releaser) from bringing any claims against you in the future for any claims before signing the release.

Keep this in mind: If you have a dispute with another party that is eventually settled, it's imperative that you have the other party sign a general release form before giving any money or consideration.

While we're on the topic of consideration, you must actually give a consideration for the release to make it legally binding. In other words, you can't just ask someone to sign a release with nothing in return. A promise by you to waive your own legal rights against the releasor may be insufficient consideration. Even if you don't think the other party deserves it, giving someone a few hundred bucks may be a good idea to have a sufficient release. (Refer to the sample General Release form in Appendix 9.)

Get Educated on Tax Issues

The foolish investor waits until April 15 to file his or her taxes, and then hands a shoebox full of receipts to the accountant. Be sure to plan for your taxes at the beginning of the tax year and consult with your tax advisors throughout the year. People who say the tax system isn't fair are just ignorant of the rules. Taxes will eat up a large percentage of your income over your lifetime so learn how to make the rules work for you!

Basic Taxation Rules

You must become schooled in the basic rules of federal taxation as they apply to real estate. The biggest expense you'll pay in your life is taxes. We suggest you learn how to reduce your taxes, which is the easiest way to have more profit in your business.

Take time to learn the difference between capital gains and ordinary gains. Ordinary income is taxed at ordinary rates, which is the same rate as wages earned from an employer. This can prove to be unfortunate for those who work extra hours and get taxed on their wages. The system is set up to penalize wages and reward investments. If you buy an investment property and hold it for 12 months or more, this is considered a long-term capital asset. When you sell the property then this long-term capital asset results in a long-term capital gain. The long-term capital gains tax rate as of January 2007 maxes out at 15 percent, depending on your income. This rate is significantly lower than regular personal income tax rates, which can be as high as 35 percent.

Learn how to use depreciation to your advantage. If you hold a property as a rental, you can deduct mortgage interest and property tax payments as well as other operating expenses. You can also take depreciation for the structures; in fact, you're required to do so under IRS rules. For example, if a property is valued at $150,000 and the land is valued at $50,000, you would depreciate the $100,000 structure over 27.5 years according to the federal income tax rules. The annual depreciation deduction for a $100,000 structure according to the IRS schedules is about $3,600. In this example, you can have $3,600 a year in positive cash flow without owing any taxes on this income. If you have less than $3,600 in income from this property,

Flipping Properties Doesn't Incur Tax Penalties

Many people wrongly assume that flipping properties causes an investor to incur a tax penalty or other negative tax consequences. This assessment isn't completely accurate. A flip generally means the property is bought and sold within 12 months or less, which means the property is taxed as an ordinary gain (same rate as personal income) versus a long-term capital gain (maximum 15 percent). In other words, the federal income tax rates on a flip are the same as your ordinary income tax rates you pay on income from wages.

you'll end up a "loss," at least on paper. You can use this loss to "wash" other income you have as long as you meet certain rules. For example, if you make $100,000 a year from your business or job, a loss from your real estate activities will reduce your taxable income so you end up paying fewer taxes on that income when your taxes are due the following year.

To be able to take a loss on your taxes from rental properties, the first rule you must meet is "active participation." That is, you must show you're actively involved in managing the property, which usually isn't hard to do when you're showing properties to tenants.

The second rule is that your gross income doesn't exceed $100,000 for the particular tax year in which you're trying to take the loss. If you meet these two rules, you can deduct up to $25,000 in losses. If you're considered a real estate professional, you're not limited by the $25,000 loss cap. Therefore, if you begin investing full time, it'll be easy to meet this rule—as long as you can show you work the requisite number of hours (750 a year) and it's more than 50 percent of what you do with your work time.

If you sold a rental property and took depreciation, the depreciation is "recaptured" at sale, resulting in a gain. The depreciation re-