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Sixth Edition

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GARY W. ELDRED, PHD

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INVESTING

in

REAL ESTATE

Sixth Edition

Gary W. Eldred, PhD

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Prologue

INVEST IN REAL ESTATE NOW!

Nearly everywhere I speak these days, someone from the audience asks, "Do you feel the real estate market will drop further? Have we reached bottom yet? When do you think property prices will fully recover?"

I answer, "I do not know. I really do not care. And neither should you."

Why do I give such seemingly flip answers? First, because they are true. All investment pros encourage you to focus on your wealth-building goals—not profit maximization per se. Waiting for the bottom merely gives you an excuse to procrastinate. I've seen would-be investors make this mistake a thousand times.

And second, because the questions are ill-formed. They miss identifying the multiple ways that you can profit with property. To invest successfully in real estate, you need not, and should not, focus on predicting market valleys (or peaks). More productively, think in terms of possibilities, probabilities, and strategy—not merely the lowest price.

WHAT ARE YOUR POSSIBILITIES?

If you asked financial journalists (or their quotable experts) whether you should now invest in real estate, you would likely receive a variety of answers. But nearly all of their answers would focus on one central point: the expected direction of short-term price movements.

Journalists and their media molls love to play the game of short-term forecasting. They do it with stocks, gold, commodities, interest rates, and, for the past 10 years, properties. Are prices climbing? Buy. Are prices falling? Get out and go sit on the sidelines. As a result of their obsession with short-term price movements, the media have distorted and confused the idea of investing in real estate.

In contrast to media hype, the most experienced and successful real estate investors do not weight their deal analysis with any significant emphasis on short-term price forecasts. Instead, we typically look to an investing horizon of three to 10 years (or longer). More important, we realize that in addition to price increases, property provides us with many possible sources of return. Here are some (but certainly not all) of these profit possibilities.

- Earn price gains from appreciation.
- Earn price gains from inflation.
- Create unleveraged cash flows.
- Use leverage to magnify returns from price gains.
- Use leverage (financing) to magnify returns from cash flows.
- Grow equity gains through amortization.
- Refinance to increase cashflows
- Refinance to generate cash (lump sum).
- Buy at a below-market-value price.
- Sell at an above-market-value price.
- Create value through smarter management.
- Create value through savvy market strategy.
- Create value by improving the location.
- Subdivide your bundle of property rights.
- Subdivide the physical property.
- Create plottage (assemblage) value.
- Convert the use (e.g., residential to offices, retail to offices).
- Convert type of tenure (e.g., rental to ownership).
- Shelter income from taxes.
- Shelter capital gains from taxes.
- Create and sell development/redevelopment rights.
- Diversify away from stocks and bonds.

I explain each of these possible sources of return in Chapter 1 and then illustrate and elaborate to varying degrees in the chapters that follow. With this extensive range of possibilities in view, you can always find profitable ways to invest in real estate.

Unlike investing (or speculating) in stocks, bonds, gold, or commodities, you can generate returns from properties through research, reasoning, knowledge, and entrepreneurial talents. In contrast, when you buy stocks, you had better pray that the market price goes up, because that's your only possibility to receive a reasonable return.*

WHAT ARE YOUR PROBABILITIES?

In the correction part of the real estate cycle, fear looms. Cash balances in banks build up. Investors and savers join in a flight to quality. They willingly accept certificates of deposit (CDs) that pay low-single-digit interest rates. Investors think, "Who cares about return *on* capital? I just want to feel confident that I receive a return *of* capital.

In his highly regarded book *The Intelligent Investor*, Benjamin Graham created the parable of Mr. Market. Mr. Market represents that crowd mentality whose moods swing like a pendulum from irrational exuberance to bewildered fear and confusion. Which market mood provides the best investment opportunities/possibilities? Which market mood throws investors the highest amount of actual risk? Which market mood corresponds to the least amount of actual risk?

Booms Increase Actual Risk

You know the answers. During the irrationally exuberant boom times, investors perceive little risk, but actual risks loom larger and larger as prices climb higher and higher, income yields fall, and unsustainable amounts of mortgage debt pile up.

In Las Vegas, so-called investors (actually speculators) believed that flipping properties paved their way to wealth. Few perceived that their property risks actually laid down poorer odds than the slots at Harrah's. And who but a fool (or Panglossian optimist) would borrow money to play the slots? Yet Las Vegas property buyers loaded up with excessively high loan-to-value (LTV) ratios of 90, 95, and 100 percent (or more). They merely assumed that the future would continue to pay off as they had experienced in the recent past.

On many of their properties, loan payments (principal, interest, taxes, and insurance [PITI]) approached $2,000 a month. Potential rents for the same properties would reach no more than $1,200 a month. When an alligator is chewing your leg off, you are in a world of danger (and a world of hurt). As I have written in nearly every one of my books, high debt, low income yields, and exaggerated hopes for outsized continuing

* With property, I have earned per annum returns of 25 percent or more—without a single dollar of price gain.

increases in price (for either stocks or properties) always trigger a reversal of fortune. (See especially my *Value Investing in Real Estate*, John Wiley & Sons, 2002.)

The speculative buying of Las Vegas houses serves as an outside-the-norm example. Few other areas experienced such heightened frenzy among both builders and buyers. Nevertheless, irrational exuberance infested the moods and minds of property buyers throughout many of the world's principal cities (though during the boom of late, not Dallas, Berlin, or Tokyo—each had suffered its own irrationally exuberant property market 15 to 20 years back, and sat out this most recent party). In nearly every instance, borrowed money fueled property prices upward without commensurate growth in rent collections or personal incomes.

Market Corrections Vanquish Market Risk

Within a few short years, many property markets have shifted from sellers' markets driven by loose lending and buoyant dreams of fast, easy money to buyers' markets sustained by stricter credit standards, record numbers of foreclosures, a 25-year high in unemployment, and multiple major banks taking hits for unprecedented amounts of losses. No wonder fear and confusion have chased many potential property investors out of the game.

So here is the $64,000 question: How should you interpret these and other dismal facts from the dismal science? Do lousy economic conditions diminish your chance to build a prosperous and secure future by investing in property? Or do they vanquish market risk?

To make this question of risk easier, first address the following 10 issues. When is the best time to acquire investment property:

1. (a) When builders are bringing to market near-record numbers of new houses, condominiums, and condominium conversions, or (b) when new housing starts have fallen to the lowest level since before 1959?
2. (a) When buyers flock to open houses and beg sellers to accept their above-asking-price bids, or (b) when investors and home buyers remain relatively scarce?
3. (a) After economic recovery pushes interest rates higher, or (b) when interest rates sit near the low end of the past 40 years?
4. (a) When inflation seems subdued (as occurred during the past eight years), or (b) (as today) when massive amounts of

government borrowing and huge increases in the money supply seem sure to push inflation (and interest rates) to higher levels within the coming decade?

5. (a) When properties sell for prices at a 20 to 50 percent *premium above* their replacement costs, or (b) when you can buy properties at a 20 to 50 percent *discount below* their replacement costs?
6. (a) When millions of home buyers overleverage to purchase houses that they cannot afford, or (b) when stricter credit and high unemployment lead many people to double up (or even triple up) on their housing?
7. (a) When most sellers can hold out for top dollar, or (b) when financial distress and more than one million foreclosures/REOs create millions of desperately motivated sellers?
8. (a) When property prices sit in the clouds well above the level that rents will support, or (b) when market values fall to the point where income yields make sense and investors can reasonably expect to achieve positive cash flows—either immediately or within a few years?
9. (a) When hundreds of thousands of new investors overleverage themselves to buy rental properties that they do not know how to manage, or (b) when those same starry-eyed investors rudely awaken to the fact that successful investing requires reserves of cash and credit, knowledge, thought, and an operating system and strategy?
10. (a) When economic recovery and increasingly positive news propel millions of backbenchers into the game, or (b) now?

If you've answered (b) to each of these 10 issues, you display the courage and foresight to become a great investor. You know that market corrections vanquish risk and multiply your possibilities for profit.

Never Wait for Market Peaks or Bottoms

To invest successfully, never try to time a market bottom—or a market top. Neither you, I, nor anyone else can develop that skill. Why? Because more often than not, random events trigger short-term turns in markets. We can tell when markets are becoming too pricey. We can tell when market conditions greatly favor investors. But only by extraordinary luck can we pick the one best time to sell or buy. (Just as importantly, the way you negotiate a deal can create as much or more opportunity for you than the market conditions themselves.)

My Texas Example I owned properties in Texas in the early 1980s. By mid-1984, I had sold all of them (at substantial gains). The market continued to go up. Property agents told me that I shouldn't have sold. Later, after the crash in 1985, they told me that I had sold too soon. What do you think?

When do you replace the tires on your car? At the last possible moment before they blow out? Or when you see the tread wearing down and the risk of a blowout increasing? If you want to save your life, do not try to run your tires until the last possible moment.

Likewise with property, when irrational exuberance fuels prices ever higher and these prices are unsupported by rent levels or personal income growth, risk builds excessively. Prudence sells to save profits. Only fools hold on to capture the last dollar—or the last 1,000 miles from that risky, worn tire. And only bigger fools believe that tires or booms will last forever.

Look for Solid Value—Not Necessarily a Market Bottom or Market Boom Today's markets offer multiple low-risk, high-profit possibilities. Over a time horizon of three to five years—if you follow the principles laid out in this book—you will enjoy strong profits. I encourage you to get in the game now. No one can predict the course of prices during the next year or two. But today, you can certainly find solid values in most markets.

In my experience, two major mistakes prevent people from profiting with property: (1) They wait too long to exit an irrationally exuberant market, and (2) they wait too long to take advantage of the possibilities that are theirs for the taking.

DEVELOP AND EXECUTE YOUR STRATEGY NOW

As you read through the following pages, you will discover how property provides at least 22 sources of financial returns. Plus, you will discover multiple ways to harvest those returns.

Buying, improving, and holding income properties—especially when you purchase them at bargain prices and finance with smart leverage—offers the surest, safest, and, yes, even the quickest way to build wealth. But even long-term investors such as myself will venture along other avenues when clear opportunities arise.

In addition to the buy, improve, and hold approach, other techniques include discounted paper, real estate investment trusts (REITs), condominium conversions, fix and flip, adaptive reuse, tax liens, mobile home parks, self-storage centers, lease options, triple net leases, and other possibilities to profit through property.

If you want a secure future—a future free of financial worries, a life that you can live as you would like to live—property, especially property in today's markets, provides a near-certain route to wealth. All that remains is for you to choose, develop, and execute your own strategy now.

ACKNOWLEDGMENTS

Many people have contributed directly and indirectly to this sixth edition of *Investing in Real Estate*. Because of their efforts, this best-selling classic text on property investing has been made even better.

Accordingly, I thank Donald Trump and Michael Sexton for inviting me to work with Trump University to help create some of the best real estate educational products and services available (e. g., Trump University books—all published by John Wiley & Sons—CDs, seminars, online courses, webinars, and coaching programs). Working with the Trump team and Trump University students has broadened and deepened my perspectives on property investing as well as how to simply and effectively convey that knowledge to property investors at all levels of experience.

I also express my appreciation to Dr. Malcolm Richards, dean of the School of Business and Management at the American University of Sharjah (AUS). In recognizing the critical need for real estate education in the Middle East—and especially the hyper-growth Sharjah/Dubai metroplex—Dean Richards carved out a rewarding position for me from which I have added substantively to my knowledge and analytical abilities as they apply to international property markets. Under Dean Richards, the School of Business and Management of AUS has established itself as the premier school for business education in the Middle East—and I am pleased to have been able to participate in its development. My assistants at AUS, Mohsen Mofid and Sadaf Ahmad Fasihnia, too, deserve recognition for their cheerful and competent assistance in all of my writing and teaching activities. (Alas, both have now graduated and I will miss them greatly.)

My best-selling real estate titles—including *Investing in Real Estate*—have been translated into numerous foreign languages such as Russian, Indonesian, Vietnamese, and Chinese. Thanks go to the skillful translators of these volumes and to my Asian property adviser, Sit Ming (Laura) Lee.

Last but far from least, I thank my supervising editor, Shannon Vargo; senior production editor Linda Indig; and the entire staff at John Wiley & Sons, with whom I always enjoy working. This edition of *Investing in Real Estate* marks the 23rd manuscript that I have completed for this 200-year-old company that represents the finest publishing traditions. I look forward to completing many more.

Gary W. Eldred

Vancouver, Canada
August 2009

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WHY INVESTING IN REAL ESTATE PROVIDES YOU THE BEST ROUTE TO A PROSPEROUS FUTURE

"Older workers rush back into the jobs market as downturn wrecks their retirement portfolios," so headlined a recent front-page article in the *Financial Times* (May 9, 2009). Other major newspapers such as the *Wall Street Journal*, the *New York Times*, and *Investor's Business Daily* have run similarly disconcerting articles.

The *Financial Times* article (and others similarly written) depart from the mainstream media view that dominates. For the past 15 years, most major media—and especially personal finance magazines such as *Money, Smart Money,* and *Kiplinger's*—have primarily served up inept mantras for the masses disguised as financial wisdom. Such widely read magazines and newspapers have published hundreds (quite likely thousands) of articles that promise investors that they can achieve wealth without work, effort, or thought.

Just keep pouring monthly payments into your IRAs, 403(b)s, and 401(k)s and you will enjoy financial security. "Over the long run stocks outperform all other investments. Over the long run stocks will protect you against inflation."

Indeed, just as I was about to write this chapter, voilá, my local paper obliged with a perfect example. A reader, Nasir Iqbal, posted this comment: "I don't trust stocks. I think I will receive higher returns with property. With property, I will feel financially secure when I retire."

The journalist, Cleofe Maceda, responded as follows:

> Is buying property the right way to secure your retirement? Experts [sic] say people like Iqbal are better off looking into other avenues for capital growth—which can reduce the long-term risk of running out of income in retirement.

Maceda (the journalist writing the article) then quotes one of his so-called experts,

> The challenge with property is that you can only sell it for what people are willing to pay. [Duh?] It can take two years or longer to sell a property. There is no liquidity with property.

Continuing a bit further in this article, the journalist again quotes his expert.

> Stock markets offer the best possibility to beat inflation over periods of five years or more. This is because shares produce dividend income in addition to the ability to grow in price.

As to volatility—that other big issue that confronts investors—the mantra persists. No need to worry about 30 to 50 percent drops in the stock markets. . .

> . . . that volatility can work for an investor's advantage because it allows them to maximize their buying power [i.e., when stock prices fall, your $1,000 a month deposits (or whatever) buy more shares].

In one short article, Maceda scores six out of six widely popularized, yet false claims:

1. Stocks outperform all other assets.
2. Liquidity favors stocks.
3. Stocks pay you good income.
4. Stocks protect you against inflation.
5. Stocks reduce the risk of running out of money in retirement.
6. You don't really lose when your stock portfolio crashes, you gain.

Evidently, Maceda—like a majority of journalists (and investors)—prefers not to think for himself. He prefers not to look at the actual historical record of stocks. He prefers to remain ignorant of property. Standing against conventional wisdom, the *Financial Times* (at least in the article quoted) has captured the sad reality of stocks. Maceda only perpetuates the mantra manufactured by Wall Street.

This chapter sets the record straight. It provides you (and Nasir Iqbal) a more enlightened perspective on property, stocks, and several other asset classes (bonds, annuities) that investors might turn to as they strive to build wealth and achieve financial security.

22 SOURCES OF RETURNS FROM INVESTMENT PROPERTY

When so-called experts compare property with stocks, they rarely get their comparisons right. More often than not, they assume that property yields only one source of return that counts: potential gains in price. For example, in his acclaimed book, *Winning the Loser's Game*, Charles Ellis concludes that:

> Owning residential real estate is not a great investment. Over the past 20 years, home prices have risen less than the consumer price index and have returned less than Treasury bills.

Leaving aside for a moment how and where Ellis came up with his long-term house price figures—no statistics I have ever seen report that housing, relative to incomes or consumer prices, has become cheaper—Ellis (and other finance/economics types) err most egregiously in how investors should measure the total potential returns that property offers. Ellis omits at least 20 other sources of financial returns that investors can earn from their portfolio of properties.[1]

To evaluate property, certainly weigh the possibilities for price gains, but go further. You can earn double-digit rates of return (and sometimes much more) from your property investments—even without any gain in price.

It's up to you to decide which sources of returns best fit your investment goals—and correspondingly, for each property you evaluate, which sources of return seem doable. Few properties present a full range of possibilities. But to fully see potential, apply each test of possibility

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[1] His two-decade time horizon also fails as a representative period because it includes the late 1970s and the 1980s—treasuries paid record-high interest rates during those years.

to all properties you consider. Every property presents multiple sources of returns.

Will the Property Experience Price Gains from Appreciation?

In everyday speech, most people do not differentiate price gains that result from appreciation and those that result from inflation. Appreciation occurs when demand grows faster than supply for a specific type of property and/or location. Inflation tends to push prices up—even if demand and supply remain in balance.

Homes in Central London, San Francisco's Pacific Heights, and Brooklyn's Williamsburg neighborhood have experienced extraordinarily high rates of appreciation during the past 15 to 20 years. And just since 1990, houses within a mile or so of the University of Florida campus have tripled in market price—primarily because UF students and faculty alike now strongly prefer "walk or bike to campus" locations.

Areas Differ in their Rate of Appreciation. Although properties located in Pacific Heights and Williamsburg have jumped in value at rates much greater than the rise in the Consumer Price Index (CPI), some neighborhoods in Detroit have suffered major declines in value. Appreciation does not occur randomly. You can forecast appreciation potential using the right place, right time, right price methodology discussed in Chapter 15.

Likewise, you need not get caught in the severe and long-term downdrafts that plague cities and neighborhoods that lose their economic base of jobs. Just as various socioeconomic factors point to right time, right place, right price, similar indicators can signal wrong place, wrong time, wrong price.

You Do Not Need Appreciation. Should you always invest in properties that are located in areas poised for above-average appreciation? Not necessarily. Throughout the rest of this chapter, I show you many ways to profit with property. Some investors own rental properties in deteriorating areas—yet still have built up multimillion-dollar net worths. My first properties did not gain much from price increases (appreciation or inflation)—but they consistently cash flowed like a slot machine payoff.

If you choose a fast money, flip and fix strategy, appreciation doesn't count for much either. Also, when you buy at a price 10 to 30 percent below market value, you earn instant appreciation that is not related to market temperature. Throw away the urge to believe that you can't make good money with property unless its market price appreciates.

Will You Gain Price Increases from Inflation?

In his book, *Irrational Exuberance*, the oft-quoted Yale economist, Robert Shiller, concludes that houses perform poorly as investments. According to his reckoning, since 1948, the real (inflation-adjusted) price growth in housing has averaged around 1—at best 2—percent a year.

"Even if this $16,000 house sold in 2004," says the eminent professor, "at a price of $360,000, it still does not imply great returns on this investment . . . a *real* (i.e., inflation-adjusted) annual rate of increase of a little under 2 percent a year."

Shiller Thinks Like an Economist, Not an Investor. Every investor wants to protect his wealth from the corrosive power of unexpected inflation. Even if we accept Shiller's numbers—and I believe them reasonable, though certainly not beyond critique—the data do show that property has kept investors ahead of inflation in every decade throughout the past 75 years.

Not true for stocks (or bonds). Consider the most inflationary period in U.S. history: 1966–1982. In 1966, the median price of a house equaled $25,000; the Dow Jones Index hit 1,000. During the next 18 years the CPI jumped from 100 to 300. In 1982, the median price of a house had risen to $72,000; the DJIA closed the year at 780—below its *nominal* level of 18 years earlier.

Inflation Risk: Property Protects Better than Stocks. No one knows what the future holds. Will the CPI once again start climbing at a steeper pace? At the runaway rate the U.S. government prints money and floats new debt, the odds point in that direction. During periods of accelerating inflation, most people would rejoice at just staying even.

Imagine that in the early to mid-1960s you were a true blue "stocks for retirement" kind of investor—and you were then age 45. In 1982, as you approach age 65, your inflation-adjusted net worth sits at maybe 30 percent of the amount you had hoped and planned for. What do you do? Stay on the job another 10 years? Sell the homestead and downsize? Borrow money from a wealthy friend who invested in real estate?

Property Investors Do Not Buy Indexes and Averages. Economists calculate in the netherland of aggregates and averages. Investors buy specific properties according to their personal investment objectives. An economist's average does not capture the actual price gains (inflation plus appreciation) that real investors earn.

No investor who intelligently chooses properties for their wealth-building potential selects such properties randomly. Investors apply some variant of right time, right place, right price methodologies (see page 285). If you want to outperform the average price increases of real estate—even though the averages themselves look quite good—you certainly can.

Earn Good Returns from Cash Flows

Unlike the overwhelming majority stocks, income property typically yields (unleveraged) cash flows of 5 to 12 percent.[2] If you own a $1,000,000 property free and clear of financing, you can pocket $50,000 to $120,000 a year. If you owned a $1,000,000 portfolio of stocks, you might pocket cash flows (dividend payments) of $15,000 to $30,000 a year.

Historically, the largest source of return for unleveraged properties has come from cash flow. If you want to grow a passive, inflation-protected stream of income, own income properties.

Economists and financial planners greatly embarrass themselves when they sleight or ignore this critical source of return. Before Charles Ellis, Robert Shiller, and others of their ilk again take up their pens to write on real estate, they might set aside their misguided claims of expertise on realty returns and first learn something about the actual practice of investing in real estate. If they did, they would also learn that nearly all property investors magnify their returns with leverage.

Magnify Your Price Gains with Leverage

Know-nothing economists, financial analysts, and various media-anointed experts claim that price gains from property provide real (inflation-adjusted) returns of one to two percent a year. In doing so, they omit the return-boosting power of OPM (other people's money—typically, mortgage financing).

Low Rates of Price Gain Create Big Returns. Assume you acquire a $100,000 property. You borrow $80,000 and place $20,000 down. During the following five years, the CPI advances by 50 percent. Your property, though, lagged the CPI. Its price only increased by 25 percent. Your real wealth fell, right? No, it increased.

You now own a property worth $125,000, but your equity wealth—your original $20,000 cash equity in the property—has grown to $45,000 (not counting mortgage amortization of principal). You have more than doubled your money. To have stayed even with the CPI, your equity only needed to grow to $30,000.

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[2] Yields in the U.K., Asia, and most of Europe often fall somewhat below those available throughout the United States.

Acorns into Oak Trees. Real estate investing builds wealth because it grows acorns (small down payments) into free and clear properties worth many multiples of the *original* amount of invested cash. Let's go back to that Shiller example.

The homebuyer paid a price of $16,000 in 1948. Did that homebuyer pay cash? Not likely. Ten to 20 percent down set the norm—say, 20 percent or $3,600 (.2 × $16,000). At Shiller's hypothetical 2004 value of $360,000, the homebuyer multiplied his original investment 100 times over. Even if we say the 2004 property value comes in at $180,000—the homeowner enjoyed a 50-fold increase of his $3,600 down payment.

What about stock gains during that period of 1948 to 2004? In 1948 the DJIA hovered around 200 (by the way, still about 40 percent below its 1929 peak of 360). In 2004, the DJIA stood at about 8,000—a 40-fold gain. Not bad, but still less than the gains from property (and much, much less when we bring cash flows into the comparison of returns). [Note: As I write in mid-2009, the DJIA still sits around 8,000—whereas property prices (in all but the most distressed areas) are still up from 2004 and way up from 1998, which is the year that the DJIA first hit 8,000.]

Magnify Returns from Cash Flows with Leverage

Traditionally, investors not only magnify their equity gains from leverage, they also magnify their rates of return from cash flows. You pay $1,000,000 cash for an apartment building that yields a net income (after all operating expenses) of 7.5 percent (no financing). Not bad. But if you finance $800,000 of that $1,000,000 purchase price at, say, 30 years, 5.75 percent interest, you invest just $200,000 in cash. Your net income equals $75,000 (.075 × 1,000,000) and your annual mortgage payments (debt service) will total around $56,000. You pocket $19,000 ($75,000 less $56,000). You've boosted your cash flow return (called cash on cash) from 7.5 percent to 9.5 percent (19,000 ÷ 200,000).

Build Wealth through Amortization

Assume for a moment that your $1,000,000 apartment building throws off zero cash flows. You apply every dollar of net operating income to paying down your mortgage balance of $800,000. After 20 years, you own the property free and clear. This property experienced no gain in price. It's still worth $1,000,000.

No price gains from inflation, no price gains from appreciation, and no money pocketed from cash flows. Quite unrealistic and pessimistic, right? Yet, over a 20-year period, you grew your equity from $200,000 to

$1,000,000—a five-fold gain, and annual compound growth rate of more than 8 percent.

Your tenants just bought you a $1,000,000 property. That's why I tell my students, "Rent or buy?" asks the wrong question. All tenants buy—the real question is one of ownership. If you rent, you still pay your landlord's mortgage. Your landlord reaps the rewards of ownership—while tenants bear the cost. Seems to me a great deal for property investors.

Over Time, Returns from Rents Go Up

Most property owners raise their rents. Maybe not this year. Maybe not next year. But over a period of five years or more, increasing rents yields increasing cash flows. If you've selected a right time, right place, right price location, demand will push rents up as more people want to live in the neighborhood where your property is located. Or perhaps, as government floods the economy with paper money, inflationary pressures force rents up. Either way, you gain. In fact, you can gain even if your rent increases fail to match the inflationary jumps in your expenses.

Let's return to our apartment building example. Gross rent collections equal $125,000; net operating income equals $75,000; mortgage payments equal $56,000; your cash flow equals $19,000.

Gross rents	$125,000
Vacancy and expenses	50,000
Net operating income	75,000
Annual mortgage payments	56,000
Cash flow	19,000

First, assume your rents and expenses each increase by 8 percent. Here are the revised amounts:

Gross rents	$135,000
Vacancy and expenses	54,000
Net operating income	81,000
Annual mortgage payments	56,000
Cash flow	25,000

An 8 percent increase in rents and expenses boosts your cash flow by 31 percent:

$$25{,}000 \div 19{,}000 = 1.31$$

If expenses had increased by 12 percent and rents stepped up mildly by just 6 percent per annum (p.a.), you would still increase your cash flow:

Gross rents	$132,500
Vacancy and expenses	56,000
Net operating income	76,500
Annual mortgage payments	56,000
Cash flow	20,500

$$20{,}500 \div 19{,}000 = 1.08$$

[Note: You can run multiple scenarios with these numbers and other numbers presented throughout this chapter. No results are guaranteed. Through your own market and entrepreneurial analysis, you will both estimate and create the potential returns for the properties you buy.]

But I do encourage you to realistically envision the return possibilities that property investing offers. Then as you evaluate markets, properties, and the economic outlook for your geographic areas of interest, figure the probabilities. Which sources of return look most promising? Which sources of return seem remote? What risks could upset the applecart?

Refinance to Increase Cash Flows

You increase your cash flows when you increase your rents (or decrease your expenses). You also increase your cash flows when you refinance to lower your annual mortgage payments. Today, a future refinancing at rates lower than those currently available seems somewhat remote.

But who knows? From 1930 until the early 1950s, interest rates on long-term mortgages ranged between 4.0 and 5.0 percent. A refi from a 6.5 percent, 30-year loan into a 4.5 percent, 30-year loan would not only slice your mortgage payments by 20 percent, it would lift your cash flows by an even greater percentage.

In some future time, we might again confront mortgage interest rates of 8 to 10 percent. Under those market conditions, a later refinance at lower interest rates becomes ever more likely.

(Note: Chapter 2 introduces a technique called a wraparound mortgage whereby investors can obtain the benefit of a lower-than-market interest rate through seller financing. Wraparounds give buyers a reduced interest rate and at the same time, from a seller's perspective, the wraparound creates another source of return, cf. p. 34.)

Refinance to Pocket Cash

Unless history makes a U-turn, buy a property today and within 10 to 15 years, you can sell it for 50 to 100 percent more than the price you paid. You gain a big pile of cash. But what if you do not want to sell? Can you still get your hands on some of that equity that you have built up? Sure. Just arrange a cash-out refi.

Here's how this possible source of return works. Say after 10 years your $1 million property is now worth $1.5 million. You've paid down your loan balance to $650,000. Your equity has grown from $200,000 to $850,000 ($1.5 million less $650,000). You obtain a new 80 percent loan-to-value ratio (LTV) mortgage of $1.2 million. You pocket $550,000 tax free!

But don't spend that cash. Reinvest it. Buy another income property. Yes, you now owe higher monthly mortgage payments on your first property, and your cash flows from that property will decrease. But with the additional cash flows from your second property, your total cash flows will go up. How's that for having your cake and eating it too?

Buy at a Below-Market Price

When the economists (mis)calculate the returns that property investors receive, they omit the fact that savvy buyers often acquire great properties for less than their market value. Opportunity (grass-is-greener) sellers, don't-wanter sellers, ill-informed sellers, incompetent sellers, unknowledgeable sellers—and most importantly in today's markets—financially distressed sellers all will sell at below-market prices.

And unlike in normal times, the financially stressed and distressed today not only include individual property owners but also the mortgage lenders themselves. Financial institutions now own more than a million foreclosures (called REOs) that they must sell as quickly as they can line up buyers to take these properties off their books.

How do you find and buy these properties for less than they are worth? See Chapters 5, 6, and 7.

Sell at an Above-Market-Value Price

How do you sell a property for more than market value? Find a buyer who is unknowledgeable, incompetent, or pressed by time. Offer seller financing, a wraparound, or perhaps a lease option. Develop your skills of promotion and negotiation (see Chapter 13). Match the unique features and benefits of the property. Sell the property with a below-market-interest-rate assumable (or subject-to) loan.

Sometimes buyers pay more than market value because they don't know (or do not care) what they're doing. Sometimes they pay more to obtain a much-desired feature or terms of purchase/financing. Whatever their reason, if you wish to exploit this possibility, you've created another source of return.

Create Property Value Through Smarter Management

When you manage your properties and your tenants more intelligently, you increase your rent collections (without necessarily raising your rents); you reduce tenant turnover; you increase prospect conversions; you spend less, yet spend more effectively for maintenance, promotion, and capital replacements. You enjoy peaceful, pleasant, and productive relations with tenants.

Fortunately for you, most owners of investor-size (as opposed to institutional-size) rental properties manage their investments poorly. Why fortunately? Because their mal-management provides opportunities for you. Upon acquiring a property, you can execute a more effective and competitive management strategy to increase the property's cash flows and, simultaneously, lift its market value.

How can you achieve such performance? Rely on Chapter 11 to develop your profit-maximizing management *and* market strategy.

Create Value with a Savvy Market Strategy

Although investors tend to manage their properties poorly, they show even less skill as savvy marketers. Go to the property web site, loopnet.com. Click through to a sample of listings. Look at the listing promotional information provided. Look at the property photographs. Does the agent tell a persuasive story about the property? Does the sales message position that property against the tens of thousands of competing properties that also hunger for attention? Do the photographs of properties reveal a well-cared-for property—a property that invites tenants to call it home?

I will give you the answers. No! No! No! The implication? More opportunities for you to gain competitive advantage. When you combine the management know-how and marketing strategy lessons of Chapters 11 and 13, you earn higher cash flows; you provide a better home for your tenants; and when the time to sell arises, your property will command a higher price.

Create Value: Improve the Location

A famous cliché in real estate says, "You can change anything about a property except its location." True or false? Absolutely false. As Chapter 8 shows, not only can you improve a location, but doing so also offers one of your most powerful sources of return.

Think for a moment. What does the concept of location include? What makes the location where you live desirable or undesirable? Accessibility, aesthetics, quiet, good public transportation, cleanliness, the people who live in the neighborhood, schools, parks, shopping, nightlife . . . the list could go on and on. What's the best way to improve any or all of these attributes? Community action. Examples abound throughout the United States and throughout the world.

Convert from Unit Rentals to Unit Ownership

Buy wholesale, sell retail. A grocer buys a 48-can box of tomato soup and then sells each can individually along with a retail mark-up. Property investors can execute a similar wholesale-to-retail strategy.

Buy a 48-unit apartment building; then, after completing legal approvals and documentation, sell each apartment individually. In principle, you can apply a similar condo-conversion strategy to office buildings, neighborhood strip centers, self-storage warehouse units, mobile home parks, hotels, marinas, boat storage facilities, private aircraft hangars, and other types of rental real estate where potential users might prefer to own versus rent. In each case, you typically pay less per unit (or per square foot) for an entire building than retail buyers are willing to pay for the smaller quantities of space that they require to meet their needs.

Opportunities for conversion profits never remain constant. As property markets change, potential profit margins swing between "make an easy million" to "call the bankruptcy lawyer."[3]

To capitalize on this source of return, monitor the relative per-unit prices of properties sold as rentals (income property investments) and comparable space sold in smaller sizes to end users (see pp. 172–175).

Convert from Lower-Value Use to Higher-Value Use

Assume that in your city, single-family residential (SFR) space rents for, say, \$2 per square foot (psf) (due to a severe shortage)—offices rent for

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[3] In such distressed market conditions, you might profit from reverse conversions. Buy a fractured condo and operate it as a rental property.

$1 psf (due to excess supply). Five years from now, single-family space rents for $1.50 psf (due to excessive overbuilding), and because of strong economic and job growth, office space rents for $3.00 psf. What might you do (if zoning permits)? Convert your SFR to offices.

Conversions of use typically require you to renovate (at least to some degree) the old, lower-value space use to fit the market needs of the higher-value use. But when relative prices and/or rent levels grow progressively wider, conversion of use can generate a lucrative source of returns (see p. 175).

Subdivide Your Bundle of Property Rights

When you own a freehold estate in property, you actually own an extensive bundle of divisible property rights. Such rights may include (but are not limited to):

- Air
- Mineral
- Oil and gas
- Coal
- Access
- Subsurface
- Development
- Water
- Leasehold
- Grazing
- Timber
- Solar/sunlight
- Easement

When Donald Trump built his United Nations World Tower, several nearby property owners pocketed several million dollars. Why? Because Trump paid these owners to transfer a portion of their air rights to him. After purchasing their air rights, the City of New York permitted Trump to build 80 stories instead of 40 stories, as the zoning law then specified.

When you are in Hong Kong, notice that high-rise apartments tower directly above some of the MTR stations. Developers paid the Hong Kong government for the right to use that airspace—even though the government retained ownership and use rights of the land beneath the apartment buildings.

Nearly everyone understands that property owners can sell leasehold rights to earn revenues. (Not all governments, though, permit leaseholds for all properties—and when they do, they may severely limit the terms and price of the leasehold agreement.) However, in addition to leasehold, you might sell, lease, or license other rights that derive from a freehold estate. Transferring one or more of these other rights can generate another source of return.

Subdivide the Physical Property (Space)

In one sense, condominium conversions represent one form of subdividing. But usually subdividing refers to selling or leasing land or buildings in smaller parcels, most commonly, a developer who buys 500 acres and cuts it up and sells off half-acre lots to homebuilders. For another example, consider a shut down Kmart store. A still-thriving big box retailer might pay $10 per square foot to let the entire now-vacant building.

Instead, a property entrepreneur could master lease the property and subdivide the interior space into a variety of uses such as childcare, offices, and/or smaller retail merchants. Each small tenant pays a higher ppsf (price per square foot) rental rate than would the Best Buy or Lowe's who might otherwise lease the total building. If the new space users require lower parking ratios than the old Kmart, the entrepreneur might subdivide some of the parking lot area for additional retail/restaurant uses.

Thoughtful entrepreneurs steeped in market knowledge and possibility thinking persistently search for properties to subdivide. In such cases, the sum of the parts exceeds the value when viewed as a whole.

Create Plottage (or Assemblage) Value

You create plottage or assemblage value when you combine smaller parcels into a larger parcel of land or space. Say you discover a perfect site to build a new neighborhood shopping center. Zoning and planners require a minimum of four acres for such a development. The site equals four acres but it is owned by eight different persons in one-half acre lots. Individually, the lots are worth $10,000 apiece—or $80,000 in total.

However, as a four-acre shopping site, the land would sell for $250,000. You now see how to earn a good profit. Persuade each of the current owners to sell you his lot at its current market value (or even at a price that sits somewhat above market value). Perhaps the champion assembler to create plottage value was the Walt Disney Company. Over a period of 10 years, Disney secretly accumulated 25 square miles of Central Florida land at agricultural-valued prices. Once they completed this assemblage, the value of the aggregate site probably exceeded cost by a factor of 20 (or more).

Obtain Development/Redevelopment Rights

Return to the four-acre neighborhood shopping center example. You succeed. You acquire all eight lots at a total price of $130,000 (several of those owners did not want to sell—so you sweetened your offer). Can you start building the center? No. You must first secure a long list of government permits and approvals. So, your $250,000 current site value stands independent of a government go-ahead.

With permits in place, the land could command a price of $500,000. You could sell now and take your profit. Or you could stay in the game. Spend $50,000 (or so) for lawyers, soil tests, public hearings, environmental clearance, traffic studies, and whatever else the city powers throw at you. This permit process requires (with luck—and no unanticipated delays) 6 to 12 months. If all goes as planned, you earn another $200,000.

In real estate, government approvals add to the value of any property that is ripe for development, redevelopment, renovation, conversion—or destruction.[4] Obtain those necessary permits and you earn a good-sized return.

Tax Shelter Your Property Income and Capital Gains

To build wealth, protect your income and capital gains from the greedy grasp of government. Fortunately (under current tax law), investing in real estate provides you more opportunity to avoid paying taxes than any other asset class.

Depreciation (noncash) deductions shelter all (or nearly all) of your positive cash flow. A Section 1231 exchange shelters your capital gain as you pyramid your investment properties. The $250,000/$500,000 capital gain exclusion provides you tax-free gains from the sale of your personal residence(s). A cash-out refinance (that your tenants will repay for you) deposits tax-free cash into your bank account. And if you buy a "first-time" home, the newly enacted $8,000 tax credit provides part (or maybe all) of the cash for your down payment.

Some naïve souls might object. "I can build my stock market wealth tax free through my 401(k), 403(b), and IRA plans. That tax break beats property."

Well, even if that tax break did beat property—which it doesn't—you forget that when you begin to draw on that cash during retirement, the

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[4] Yes, government even requires permits to tear down buildings. In Sarasota, Florida, the Ritz Carlton fought a four-year battle to obtain permission to tear down a historic house located on part of the site where the Ritz planned to build. In compromise, the Ritz eventually paid to move the house to another site.

government will tax every penny as ordinary income. In addition, if you want to tap into that cash kitty prior to reaching age 59-1/2 (as nearly 50 percent of Americans do), the IRS will grab 35 to 50 percent of those amounts (taxes plus penalties). If you die before you withdraw, the IRS still reaches in and pulls out its share.

To minimize loss of income and wealth to the IRS, buy investment real estate. (For a discussion of property taxes and income tax laws, see Chapter 14.)

Diversify Away from Financial Assets

Although some investors prefer stocks, those investors would prove themselves wise to diversify part of their portfolio into property.

As investment experience shows, during periods of expected and unexpected inflation, property prices have kept pace with or exceeded the rate of growth in the CPI. Even better, leverage transforms small price gains into double-digit rates of increase in your equity wealth.

Property prices show much less volatility than stock and bond prices. The recent depression, surfeit of foreclosures, and price downturns for many properties seem mild compared to the precipitous periodic drops in stock prices. Even in the hard-times property markets, prices have only fallen back to their 2004-2005 levels. As I write, all major stock indices sit below their levels of 1998.

Today, most financial planners encourage asset diversification. Historical as well as recent experience support that view. The mantra "stocks, stocks, and more stocks for retirement" does not meet the test of experience. Add property to your investments—if not for its superior returns, then to reduce your portfolio risks.

IS PROPERTY ALWAYS BEST?

Some people think that I serve as head cheerleader for investing in real estate. In one sense, they are right. The record shows that more average people have built sizeable amounts of wealth through property than any other type of savings or investment.

However, I do not say, "Property investments will beat stocks or bonds any time, any place, at any price." As early as 2005, I told my investor audiences that I would not buy property in the then-current hot spots such as Las Vegas, Miami, Singapore, Dublin, or Dubai. Speculative frenzy drove those markets—not reasoned fundamental evaluation of risks and rewards.

So, when people ask me, as they often do, "Which investment provides the best returns —stocks or real estate?" I answer, "It all depends."

Certainly, in 1989, I would rather have invested in the S&P 500 index fund than Tokyo real estate. In 1993, I would have preferred the DJIA to property in Berlin. In 1997, I would rather have bought Apple Computer stock than a Hong Kong condominium located on the Peak.

You must rely on investment and market analysis. Investors do not always make more money with property than they do with stocks. I have never said otherwise. But that begs the question, "Which investment offers the best possibilities and probabilities today?"

Given today's bargain property prices relative to where property values will likely stand 6 to 10 years from now; given the fact you can build large increases in property wealth (equity) without big gains in price; given the relative income yields of property versus stocks (or bonds); given the tax advantages of property relative to all other investments; given the multiple sources of returns that property offers; and last—but far from least—given the entrepreneurial talents that you can apply to property to increase its price and cash flows; then, yes, in today's market, I am willing to lead the cheers for investing in real estate.

2

FINANCING: BORROW SMART, BUILD WEALTH

To build wealth fast, use borrowed money. Used smart, financial leverage magnifies your gains. Used dumb, leverage not only increases your chance of loss, it magnifies the loss you incur. Smart borrowing leads you to financial security. Dumb borrowing leads to sleepless nights, drained bank accounts, and forced property sales.

As recent experience shows, excessive debt has drowned the hopes and dreams of many investors and homebuyers. To help understand why, look back to the faulty advice that (until recently) enticed millions of naïve and ill-prepared Americans to borrow dumb.

In the early days of the get-rich-quick real estate gurus, property prices were escalating 10 to 20 percent a year. Just as occurred during 2001–2006, back then nearly every would-be investor wanted to get a piece of the property action. Yet a majority of these hopeful buyers lacked cash, credit, or both. They possessed the will, but they lacked the means.

THE BIRTH OF "NOTHING DOWN"

Enter Robert Allen, Carlton Sheets, Tyler Hicks, Al Lowry, Mark Haroldson, and other promoters of "nothing down." To sell their books, tapes, CDs, DVDs, and seminars, these pundits promised the ill prepared a solution to their dilemma. "No cash, no credit, no problem." Just learn the tricks and techniques of creative finance and you too can become a real estate millionaire.[1] Not surprisingly, the property boom of late reinvigorated those guru promises of easy wealth. Scores of books, CDs, seminars and boot camps have promoted all types of get-rich schemes that tell wannabe investors that they can win big in real estate through lease options, short sales, foreclosures, flipping, and a sundry collection of other so-called no cash, no credit techniques.

In his book *Multiple Streams of Income: How to Generate a Lifetime of Unlimited Wealth* (John Wiley & Sons, 2004), Robert Allen recounts his famous boast to the skeptical *Los Angeles Times*: "Send me to any city," Allen told the newspaper. "Take away my wallet. Give me $100 for living expenses. And in 72 hours, I'll buy an excellent piece of property using none of my own money." (p. 140)

In response, the *L.A. Times* hooked Allen up with a reporter, and off they went. "With this reporter by my side," Allen writes, "I bought seven properties worth $722,715. And I still had $20 left over." The *Times* ate crow and headlined a follow-up article "Buying Homes without Cash: Boastful Investor Accepts Challenge—and Wins." "Yes, these techniques do work," Allen writes.

No question, Robert Allen and others who have preached a similar gospel are right. You *can* buy with nothing down, but that begs the real question. The real question is whether you *should* buy with little or no cash or credit.

SHOULD YOU INVEST WITH LITTLE OR NO CASH OR CREDIT?

If investing in real estate with little or no cash or credit were a sure route to wealth, this country would be awash in real estate millionaires. Indeed, more than 10 million people have bought various nothing-down books, tapes, videos, courses, and seminars. With all this knowledge of creative finance floating about, you might think that the secrets of building real estate wealth were available to almost everyone.

So where's the catch? Why, among so many who have signed up, can so few boast of success, and why have so many perished?

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[1] The term *creative finance* eludes precise definition. In general, it refers to the use of multiple sources of credit (e.g., sellers, real estate agents, contractors, partners) and out-of-the-norm financing techniques such as mortgage assumptions, subject-to purchases, land contracts, lease options, second or third mortgages, credit card cash advances, master leases, and so forth. In some circumstances, investors can use creative financing to buy real estate even though they lack cash or good credit. Each of these topics is discussed in this chapter.

What's Wrong with "No Cash, No Credit"?

To begin with, let me emphasize that many smart, experienced, and successful investors and homebuyers do use various forms of creative finance. I endorse creative finance. I use it myself.

However, we have all seen so many deals crash and burn that I advise caution. Many promoters of creative finance have oversold its advantages and underplayed its potential perils. Before you imbibe such an intoxicating elixir, think through the following issues:

Do You Live below Your Means? In their bestseller *The Millionaire Next Door* (Longstreet, 1997), Thomas Stanley and William Danko reveal that self-made millionaires typically live *below* their means. More often than not, they avoid prestige spending. They do not drive new Jaguars or BMWs, dress for success in Armani suits, spend lavishly with their platinum American Express cards, or wear $200 (let alone $2,000) wristwatches. Serious wealth builders display no foolish affectations of conspicuous consumption.

In contrast to the typical wealth builder, many of the dreamers who were attracted to the schemes of the real estate gurus never learned to spend (or invest) wisely. They primarily see real estate as a means to circumvent their money and credit problems—a quick and painless way to live the envied lifestyles of television's rich and famous.

In fact, promoters of "no cash, no credit" shamelessly encourage this lavish image. They typically display themselves in fabulous settings. Mark Haroldson's photo on the cover of his book *(How to Wake Up the Financial Genius Inside of You)* shows him lounging on the hood of a Rolls Royce. Irene and Mike Milin *(How to Buy and Manage Rental Properties)* instead chose a Mercedes 600 for their photo backdrop. And, of course, nearly everyone has seen the TV infomercial where Carlton Sheets sat by the pool enjoying a beautiful Florida bay-front estate.

Take a hard look at yourself. Is your goal to sensibly pursue the inner security and confidence of a millionaire next door? Do you presently live *well below* your means? Do you save a large percentage of your earnings? Or do you frequently fail to discipline your fiscal frivolities? Do you try to show the world you've "made it"? Do you believe creative finance techniques can override your need to shape up your financial fitness?

If a borrow-and-spend personal profile describes you, align your motives and priorities. The "no cash, no credit" gurus have lured too many people into believing that, as one such promoter puts it, "nothing down can make you rich." Wrong! Nothing down can help get you started in real estate, but only fiscal discipline can pave your path to long-term wealth and financial security. Before you look to creative finance, critically review and adjust (revolutionize, if necessary) your habits of spending, borrowing, and saving.

Price versus Terms. Some creative-finance gurus urge their students to talk sellers into creative-finance schemes with this gambit: "You set the price, let me set the terms." In this way the seller will (ostensibly) receive a price that exceeds his property's market value (along with great bragging rights). In exchange, the creative-finance buyer asks for terms that may include seller financing, little or nothing down, a below-market interest rate, lease option, or other seller concessions.

In their eagerness to jump into a "your price/my terms" deal, novice investors frequently fail to adequately inspect the property for problems. In addition, they end up owing more than their properties are worth. When problems develop that a buyer can't afford to pay for—or otherwise remedy—he or she also faces the problem of owning a property that can't be sold for a price high enough to pay off the mortgage balance. Experience shows that the financially weak and ill-prepared flock to property during boom times with no idea that (in the short run) quick advances in price often signal a coming downturn.

The lesson: Anytime you agree to pay more than a property is worth, you invite financial trouble. The terms of creative finance can seldom overcome the tenuous position that an overfinanced, overpriced property presents. (You'll see a specific financial example of "you name the price, I'll set the terms" later in this chapter.)

Credibility versus Creativity. Many would-be investors use creative financing techniques not just to buy with little or nothing down but also to work around credit problems (no credit record, slow pay, write-offs, bankruptcy, foreclosure, self-employment, etc.). Nevertheless, regardless of your credit history, before you can arrange any type of sensible financing, establish your credibility.

Yet credibility and creativity often clash. In contrast to the boom years, today's dealmakers have wised up. If you suggest a deal that seems strange, risky, or simply off-the-wall, other would-be participants in the transaction (broker, seller, mortgage lender) may doubt that you really know what you're doing. Or they may come to believe that you lack financial resources, experience, or both.

Before you try to negotiate a creative-finance scheme, sound out the views and possible responses of the other players in the deal. If you go too far from the reasonable, others may simply walk away and dismiss you as a fake (big hat, no cattle). For your failure to establish credibility, you'll lose good properties.

Perseverance versus Productivity. Nearly all "no cash, no credit" gurus admit (at least in their fine print) that the majority of sellers, brokers, and mortgage lenders will reject most of their financing techniques. "How often does a transaction like this happen?" Robert Allen (*Multiple Streams of Income,* p. 142) asks rhetorically after explaining one of his zero-down techniques. "Very rarely. One in a hundred. It takes luck, chutzpa, and quick feet."

Now, ask yourself: Will the search for creative finance lead to success? For many in the past, that answer has been no. When these previously eager investors have met repeated rejection and disappointment, they gave up. They came to see real estate "investing" as a waste of time.

In doing so, they missed the success they could have enjoyed had they prepared themselves financially and pursued conventional financing and acquisitions. In other words, if you chase after deals that stand little chance of profitable completion, steel yourself against slammed doors and fatigue. To achieve creative possibilities, persevere. Realize, too, that most investors who build long-term wealth and financial security not only design and forecast their potential rewards from a deal, they anticipate risks. They build contingency plans to follow when events turn against them.

Leverage: Pros and Cons

Never assume that good refinance possibilities will exist at the time you most need them. Never let anyone tempt you into believing any deal represents a sure thing. Rents can fall. Vacancies can increase. In the short run, you may not be able to sell your property at a price high enough to pay off your loan(s). Interest rates can go up, and loan-underwriting standards can tighten. Today's foreclosures are multiplying (in part) because of the false beliefs and assumptions that lay behind "no cash, no credit, no problem."

Leverage Magnifies Returns. With risks in view, now the good points. The term *leverage* means that you employ a proportionately small amount of cash to acquire or control a property. To illustrate: you buy a $100,000 rental property that produces a net operating income (NOI) of $10,000 a year.[2] If you finance this unit with $10,000 down and borrow $90,000 (a *loan-to-value ratio* of 90 percent), you highly leverage your purchase.

You own and control a property. Yet you put up only 10 percent of the purchase price, whereas if you paid $100,000 cash for the property, you would not have leveraged your purchase (no OPM).

But leverage can magnify your cash-on-cash returns. The following four examples calculate rates of gain in equity from price increases based on alternative down payments of $100,000 (an all-cash purchase), $50,000, $25,000, and $10,000.

[2] Obviously, in high-priced areas of the country, $100,000 won't buy a studio apartment. But to illustrate, it's an easy figure to work with.

Example 1: $100,000 all-cash purchase

$$\begin{aligned} \text{ROI (return on investment)} &= \text{Income (NOI)/Cash investment} \\ &= \$10{,}000/\$100{,}000 \\ &= 10\% \end{aligned}$$

In this example, you pocket the full $10,000 of net operating income (rental income less expenses such as insurance, repairs, maintenance, and property taxes). Now, if you instead finance part of your purchase price, you will make mortgage payments on the amount you borrow. If we assume you find financing at 8 percent for 30 years, you will have to pay your lender $7.34 a month for each $1,000 you borrow. Now, using various percentages of leverage, the subsequent examples show how to magnify your rates of return.

Example 2: $50,000 down payment; $50,000 financed. Yearly mortgage payments equal $4,404 (50 × $7.34 × 12). Net income after mortgage payments (which is called cash throw-off) equals $5,596 ($10,000 NOI less $4,404).

$$\text{ROI} = \$5{,}596/\$50{,}000 = 11.1\%$$

Example 3: $25,000 down payment; $75,000 financed. Yearly mortgage payments equal $6,607 (75 × $7.34 × 12). Net income after mortgage payments (cash throw-off) equals $3,394 ($10,000 NOI less $6,606).

$$\text{ROI} = \$3{,}394/\$25{,}000 = 13.6\%$$

Example 4: $10,000 down payment; $90,000 financed. Yearly mortgage payments equal $7,927 (90 × $7.34 × 12). Net income after mortgage payments (cash throw-off) equals $2,073 ($10,000 NOI less $7,927).

$$\text{ROI} = \$2{,}073/\$10{,}000 = 20.7\%$$

With the figures in these examples, the highly leveraged (90 percent loan-to-value ratio) purchase yields a cash-on-cash return that's double the rate of a cash purchase. In principle, the more you borrow, the less cash you invest in a property, and the more you magnify your cash returns. Of course, the *realized* rate of return you'll earn on your properties depends on the actual rents, expenses, interest rates, and purchase prices that apply to your properties. Work through those numbers at the time you buy to see how much you can gain (or lose) from leverage.

Now, for better news. Here's a greater way that leverage can magnify your returns and help you build wealth faster.

Over the years (if well-selected), your rental properties will increase in price. If the price of that \$100,000 property we've just discussed increases at an average annual rate of 3 percent, you earn another \$3,000 a year. If its price increases at an annual rate of 5 percent, you'll gain \$5,000 more a year. And at a 7 percent annual rate of appreciation, your gains will hit \$7,000 a year.

Add together annual rental income *and* annual price gains, and you'll gain these combined returns:

$$\text{Total ROI} = \text{Income} + \text{Appreciation/Cash investment}$$

Example 1: \$100,000 all-cash purchase and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

$$\begin{array}{ll} \text{(a)} & \text{Total ROI} = \$10{,}000 + \$3{,}000/\$100{,}000 = 13\% \\ \text{(b)} & \text{Total ROI} = \$10{,}000 + \$5{,}000/\$100{,}000 = 15\% \\ \text{(c)} & \text{Total ROI} = \$10{,}000 + \$7{,}000/\$100{,}000 = 17\% \end{array}$$

Example 2: \$50,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

$$\begin{array}{ll} \text{(a)} & \text{Total ROI} = \$5{,}596 + \$3{,}000/\$50{,}000 = 17.2\% \\ \text{(b)} & \text{Total ROI} = \$5{,}596 + \$5{,}000/\$50{,}000 = 21.2\% \\ \text{(c)} & \text{Total ROI} = \$5{,}596 + \$7{,}000/\$50{,}000 = 25.2\% \end{array}$$

Example 3: \$25,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

$$\begin{array}{ll} \text{(a)} & \text{Total ROI} = \$3{,}394 + \$3{,}000/\$25{,}000 = 25.6\% \\ \text{(b)} & \text{Total ROI} = \$3{,}394 + \$5{,}000/\$25{,}000 = 33.6\% \\ \text{(c)} & \text{Total ROI} = \$3{,}394 + \$7{,}000/\$25{,}000 = 41.6\% \end{array}$$

Example 4: \$10,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation.

$$\begin{array}{ll} \text{(a)} & \text{Total ROI} = \$2{,}073 + \$3{,}000/\$10{,}000 = 50.7\% \\ \text{(b)} & \text{Total ROI} = \$2{,}073 + \$5{,}000/\$10{,}000 = 70.7\% \\ \text{(c)} & \text{Total ROI} = \$2{,}073 + \$7{,}000/\$10{,}000 = 90.7\% \end{array}$$

When you combine returns from annual net rental income and price increases, highly leveraged properties *may* produce quite strong annual rates of return—*even without unrealistically high average annual rates of price increases.* That's why even small investors in rental properties have (over time) built net worths that run into the millions of dollars. When you own rental properties, steady rent and price increases grow acorns (relatively low down payments) into oak trees (property equity worth hundreds of thousands [or millions] of dollars). As the years pass and you pay down your mortgage balances, a property portfolio of just 6 or 8 houses or perhaps 12 to 16 apartment units (sometimes less) can build enough wealth to guarantee a secure and prosperous future. (Note, too, how these income property rates of return outshine the widely believed [yet overstated] 10 percent average annual gains that the stock market has supposedly produced since 1926.)

Manage Your Risks. The advocates of get-rich-quick real estate schemes often fail to warn their followers that highly leveraged real estate magnifies risks as well as returns. As a result, many naïve real estate investors have lost their shirts. These buyers optimistically expected the market values of their properties to show price gains of 10 to 20 percent a year. They lost touch with reality. In fact, many "investors" barely cared what purchase prices they paid, what rent levels they collected, or how they financed their properties. They just knew that they would be able to sell their properties in a few years for twice the amount they had paid.

One such investor, for example, bought a \$300,000 fourplex with a down payment of \$30,000. After paying property expenses and his mortgage payments, the investor faced an alligator (negative cash flow) that chewed up \$1,000 a month. But the investor figured that \$1,000 a month was peanuts because he believed the sales price of the property would go up 15 percent a year. Based on that rate of gain, here's how this investor calculated the annual returns that he (unrealistically) expected to receive:

$$
\begin{aligned}
\text{ROI} &= \text{Income} + \text{Appreciation/Cash investment}\\
&= -\$12{,}000\ (12 \times -\$1{,}000) + \$45{,}000\ (.15 \times \$300{,}000)/\$30{,}000\\
&= \$33{,}000/\$30{,}000\\
&= 110\%
\end{aligned}
$$

As it turned out, this investor, like so many others, could not continue to feed his alligator \$1,000 a month. He fell behind with his mortgage payments, and as the market slowed, he was unable to sell the property.

The lender foreclosed, and the investor lost the property, his down payment of $30,000, the $24,000 of monthly cash outlays he had made before his default, and his once-high credit score.

Here are four lessons you can take away from this investor's bad experience:

1. Never expect the value of real estate, stocks, gold, antique automobiles, old masters, or any other type of investment to increase by 10, 15, or 20 percent year after year. When you need high rates of price gain to make your investment look attractive, you set yourself up for a big loss. (Avoid dot-com mania.)

2. Beware of negative cash flows. If the income you earn from an asset does not support the price you pay, you magnify your risk and chance of loss. You are speculating more than investing. That's okay if that's what you want to do. Just recognize that speculators (whether they realize it or not) play in a high-risk game.

3. Beware of financial overreach. High leverage (a high loan-to-value ratio) usually requires large mortgage payments relative to the amount of net income that a property brings in. Even if at first you don't suffer negative cash flows, vacancies, higher-than-expected expenses, or large rent concessions intended to attract good tenants can push you temporarily into the swamps where alligators feed.

Over a period of, say, 10 to 20 years, owning real estate will make you rich. But to get to that long-term future, you will likely pass through several cyclical downturns. Without cash (or credit) reserves to defend against alligator attacks, you may get eaten alive before you find the safety and comfort of high ground.

I first offered this advice in the 1995 (2nd) edition of this book. Unfortunately, many recent investors did not heed it. The more times change, the more they stay the same.

4. *Even when the financing looks "good," avoid overpaying for a property.* Overly optimistic investors buy overpriced properties with little or no down payment deals. In the earlier fourplex example, the investor agreed to pay $300,000 for his fourplex not because the property's net income justified a price of $300,000. Rather, he paid $300,000 because he was excited about his easy-credit, low, 10 percent down-payment financing. Compared with the $600,000 sales price that he expected to reap after just four or five years of ownership, his $300,000 purchase price looked cheap.

Again, I emphasize: I do not want to discourage you from making low down payments. But when you do, anticipate possible setbacks. To successfully manage the risks of high-leverage finance, follow these six safeguards:

1. *Buy bargain-priced properties.* You build a financial cushion into your deals when you pay less than market value or pay less than a property is worth—not quite the same thing. Discover how in Chapters 4 through 7.

2. *Buy properties that you can profitably improve.* To build wealth fast and reduce the risk of leverage, add value to your properties through creativity, sweat equity, remodeling, and renovation (see Chapter 8).

3. *Buy properties with below-market rents that you can raise to market levels within a relatively short period (six to twelve months).* As you increase your rental income, your mortgage payments will eat up a lower percentage of your net operating income (NOI).

4. *Buy properties with low–interest-rate financing such as mortgage assumptions, adjustable-rate mortgages, interest-rate buydowns, or seller financing.* Low interest rates help you manage high debt. Of course, high rates make debt less affordable—so beware of low interest rates that may disappear within just a few years or less.

5. *Buy right time, right price, right place properties.* "All real estate is local" is an oft-cited cliché that contains some kernel of truth. Various neighborhoods and cities offer unique differences with respect to price, location, and market timing. To reduce risk and increase rewards, proactively study and select from such opportunities (see Chapter 8).

6. *When high leverage presents an anxious level of risk, increase your down payment to lower your loan-to-value ratio and lower your monthly mortgage payments.* If you don't have the cash, bring in a money partner. Don't act penny-wise and pound-foolish. Share gains with someone else rather than risk drowning in the swamps where the alligators prey.

What Are Your Risk-Return Objectives?

Little- or nothing-down finance creates opportunities for you to magnify your returns. Smart borrowing and smart investing pyramids your real estate wealth. But the more you borrow (other things equal), the more you research and prepare for an adverse turn in the market or your property operations. When you highly leverage your properties, a slight fall in rents may push you into negative cash flows. A decline in your property's value can pull you underwater. Steer clear of sunshine-every-day optimism. Work through the numbers for the deals that come your way with various potential market changes. Decide what profits are worth pursuing and what risks you prefer to avoid.

If you can't find properties in your favored area(s) that yield the numbers you would like to see, look elsewhere. Sift your discovery from low-promise cities (neighborhoods to areas that offer better income/ appreciation potential.

MAXIMIZE LEVERAGE WITH OWNER-OCCUPANCY FINANCING

You now know the pros and cons of high leverage (little or nothing down). Use it; do not abuse it. In this respect, you can pursue low-down good possibilities with owner-occupied property financing.

The easiest qualifying and often the lowest-cost way to borrow most (or even all) of the money you need to buy a property remains owner-occupied mortgage financing. Even at the height of the credit crisis, high-LTV (loan-to-value) owner-occupied loan programs were readily available on single-family homes, condominiums, townhouses, and two- to four-unit apartment buildings. LTVs of 90, 95, 97, or even 100 percent financing populate this financial arena. If you do not arrange for owner-occupied financing (i.e., you choose not to live in the property), most lenders (banks, mortgage bankers, savings institutions) limit their mortgage loans on investment properties to a 70 percent to 80 percent loan-to-value ratio.[3] So, owner-occupied loans provide great advantage (as to LTV) relative to loans to finance rental properties. (However, some higher 85 to 90 percent investor loans are available, such as VA REOs—see Chapter 7.)

As another benefit, owner-occupants pay lower interest rates than investors. If lenders charge 6.0 to 6.5 percent for good credit, owner-occupied loans, the interest rate for investor properties will probably range between 6.5 and 7.5 percent. As a beginning real estate investor, weigh the possibilities of owner-occupied mortgage loans.

Owner-Occupied Buying Strategies

If you do not currently own a home, here's how to begin your wealth building in rental properties with little or nothing down—if you favor

[3] From the late 1990s to 2006, some lenders offered investor loans with total LTVs as high as 100 percent. When the property boom receded, such liberal lenders either went broke due to excessive borrower defaults, or tightened their qualifying to match or exceed more conservative (safer) underwriting standards.

this approach. Select a high-LTV loan program that appeals to you.[4] Buy a one- to four-unit property. Live in it for one year, then rent it out, and repeat the process. Once you obtain owner-occupied financing, that loan can remain on the property even after you move out. Because the second, third, and even fourth homes you buy and occupy will still qualify for high-LTV financing (low or nothing down), within a period of 5 or 6 years, you can accumulate as many as 8 to 16 rental units in addition to your own residence—all without large down payments.

You can work this homeowner gambit three or four times, possibly more. But you may not be able to pursue it indefinitely. At some point, lenders may shut you off from owner-occupied financing because they will object to your game plan. Nevertheless, serial owner-occupancy acquisitions make a great way to accumulate (at least) your first several income properties.

Current Homeowners, Too, Can Use This Method

Even if you own your own home, weigh the advantages of owner-occupied financing to acquire your next several investment properties. Here's how: Locate a property (condo, house, two- to four-unit apartment building) that you can buy and move into. Find a good tenant for your current house/condo. Complete the financing on your new property and move into it. If you like your current home, at the end of one year, rent out your most recently acquired property and move back into your former residence. Alternatively, find another "home" to buy and again finance this property with a new owner-occupied, high-leverage, low-rate mortgage.

Why One Year?

To qualify for owner-occupied financing, you must assure the lender that you intend to live in the house for at least one year. *Intend,* however, does not mean *guarantee.* You can (for good reason, or no reason) change your mind. The lender may find it difficult to prove that you falsely stated your intent at the time you applied for the loan. Beware: Do not lie about your intent to occupy a property. Lying violates state and federal laws, and governments will prosecute.

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[4] Many of these programs are described with more detail in my book, *The 106 Mortgage Secrets That Borrowers Must Learn—But Lenders Don't Tell, Second Edition* (John Wiley & Sons, 2008).

During the past property boom, borrowers lied and loan reps winked. Many borrowers and loan reps failed to comply with the "intent-to-occupy" rule. In fact, a loan rep at Wachovia (a bank that subsequently went bust) suggested that I finance a new rental house that I was buying as if it were a second home. I declined.

To succeed in real estate over the short and long term, establish, maintain, and nurture your credibility with lenders—and everyone else with whom you want to make deals or build a relationship of trust. To slip through loopholes, make false promises, sidestep agreements, or engage in other sleights will destroy your reputation for integrity. Unless you encounter an unexpected turn of events, honor a lender's one-year occupancy requirement.

Where Can You Find High-LTV Owner-Occupied Mortgages?

Everywhere! Even in today's tighter credit market: Look through the yellow pages under "mortgages." Then start calling banks, savings institutions, mortgage bankers, mortgage brokers, and credit unions. Mortgage lenders advertise in local daily newspapers and on the Internet. Check with your state, county, or city departments of housing finance. Many homebuilders and Realtors know of various types of low- or nothing-down home finance programs. Explore the web sites, hud.gov, va.gov, homesteps.com (Freddie Mac), and fanniemae.com.

WHAT ARE THE LOAN LIMITS?

The specific maximum amount you can borrow under these high-LTV programs varies by type of loan and area of the country. However, the loan limits are high enough to finance properties in good neighborhoods. For example, Freddie Mac and Fannie Mae programs nationwide will lend up to the following amounts (usually adjusted upward each year):

No. of Units	Contiguous States, District of Columbia, & Puerto Rico	Higher-Priced Areas
1	$417,000	$729,750
2	$533,850	$934,200
3	$645,300	$1,129,250
4	$801,950	$1,403,400

FHA varies its loan limits by county. Here are several examples:

Low-Cost Areas (FHA/HUD)

Type of Residence	*Loan Limits*
One-unit	$271,050
Two-unit	347,000
Three-unit	419,425
Four-unit	521,250

High-Cost Areas (FHA/HUD)

Type of Residence	*Loan Limits*
One-unit	$729,750
Two-unit	934,200
Three-unit	1,129,350
Four-unit	1,403,400

For VA loans, eligible veterans may originate—and veterans and nonveterans alike may assume—up to the following amounts:[5]

Lowest-Price Areas	Highest-Price Areas
$737,500	$417,000

Unlike Fannie/Freddy and FHA, the VA applies a single loan limit for all 1–4 unit properties. However, VA has significantly boosted its loan limit and like FHA, varies each specific limit according to the prevailing local price levels. One- to four-unit properties that are priced higher than these stated limits seldom bring in rents high enough to cover expenses and mortgage payments. So, when you select rentals that pay for themselves—even with a small down payment—the limits set by the respective insurers and guarantors should not unduly restrict your choice of properties.

[5] When a veteran makes a down payment, these loan amounts may be higher. Also, higher limits may apply in selected high-cost areas. Periodically, VA increases its limits.

HIGH LEVERAGE FOR INVESTOR-OWNER FINANCING

Assume you've reached as far as you want to go with high-LTV (low down payment) owner-occupancy financing possibilities. Or maybe you're happy in your present home. No way will you (or your spouse) move (even temporarily) to another property. Without owned occupied, what other ways help you avoid placing 20 to 30 percent of the purchase price in cash from your own savings? In other words, what high-leverage (low down payment) OPM (other people's money) techniques can you use to buy and finance your investment properties?

High Leverage versus Low (or No) Down Payment

Before we go through various low- and no-down-payment techniques, note this distinction: High leverage does not necessarily require a low down payment. High leverage means that you've acquired a property using little cash (say, 10 to 20 percent of the purchase price, or sometimes less) from your own funds.

You find a property priced at $400,000, and your lender agrees to provide a first mortgage in the amount of $280,000. Because you can't (or don't want to) draw $120,000 from your savings to make this large down payment, you need another way to raise all (or part) of these funds. If successful, you will have achieved a highly leveraged transaction. You will control a $400,000 property with relatively little cash coming out of your own pocket.

You gain the benefits (and risks) of high leverage in either of two ways: (1) Originate or assume a high-LTV first mortgage, or (2) originate or assume a lower-LTV mortgage, then to reduce (or eliminate) your out-of-pocket cash input, use other sources (loans, equity partners) to cover some (or all) of the difference between the amount of the first mortgage and the purchase price of the property.

Creative Finance Revisited

Creative finance encourages you to think through multiple financing alternatives. The term gained popularity when property prices shot up and millions of hopeful buyers felt shut out of the fast money because they lacked sufficient cash, credit, or both to enter the game. "The central theme of my course," wrote Ed Beckley in *No Down Payment Formula*, "is to teach you how to acquire as much property as you can without using any of your own money. . . . Starting from scratch requires that you become extremely resourceful. You need to *substitute ideas for cash*" (p. 69).

How might investors use creative thinking and resourcefulness to substitute for cash?

Look for a Liberal Lender. Under today's tighter underwriting, most banks and savings institutions loan only 70 to 80 percent of an (non-owner-occupied) income property's value. However, some specialty lenders will make 90 percent (or higher) LTV loans. As credit markets ease, lender competition will most likely (once again) edge up LTVs.

In addition, some wealthy private investors provide high-LTV mortgages. Find these private investors through newspaper classified ads: Advertise in the "Capital Wanted" section, or telephone those who list themselves in the "Capital Available" section. Also call mortgage brokers who may have contacts with as many as 20 to 100 sources of property financing. Through their extensive roster of lenders, mortgage brokers may find you the high LTV you want. Beware: Read the fine print. Many of these nontraditional (subprime, hard money) mortgages include costly upfront fees, high interest, and steep prepayment penalties. Foolish optimism plus subprime loan equals foreclosure.

Second Mortgages. In the past, *s*ome income property lenders permitted what are called 70–20–10 loans, or some other variation such as 75–15–10, or maybe even 80–15–5. The first figure refers to the LTV of a first mortgage; the second figure refers to the percentage of the purchase price represented by a second mortgage; and the third figure refers to out-of-pocket cash contributed by the buyer. A 70–20–10 deal for the purchase of a $100,000 property would require the following amounts:

First mortgage	$70,000
Second mortgage	$20,000
Buyer's cash	$10,000

More often than not, the property seller makes the best source for second mortgage loans. Typically referred to as "seller seconds" or seller "carrybacks," these loans require less red tape, paperwork, and closing costs. You can sometimes persuade a seller to accept an interest rate that's lower than what a commercial lender would charge. At a time when first mortgage rates were at 11 percent, and commercial second mortgage rates were at 16 percent, my seller carried back a $75,000 interest-only second at a rate of 8 percent.[6] (Sellers are more likely to offer below-market interest rates when market rates climb upwards—unlike today's low market rates.)

[6] In this case, the seller second primarily served to reduce my overall cost of borrowing thanks to its low interest rate.

My deal looked like this:

Purchase price	$319,500
First mortgage at 11%	$180,000
Seller second at 8%	$75,000
Cash from buyer	$64,500

If the sellers won't cooperate, look to private investors, mortgage brokers, banks, and savings institutions. Before you do turn to "loan-sharking" commercial second mortgage lenders, think of friends or family members who might like to earn a relatively safe return of 7 to 10 percent (more or less) on their money. Compared to certificates of deposit and passbook savings that in most times pay interest between 2.0 and 5.0 percent, a 7 to 10 percent rate of interest could look pretty good.

Borrow against Other Assets. If you're a homeowner with good credit, you can raise seed money for investment real estate by taking out a home equity loan (i.e., second mortgage) on your home. Through an equity line of credit you might raise a fair amount of cash—but remember, stay prepared for adverse changes in the market or your own finances. Alternatively, consider a high-LTV refinance of your first mortgage.

What other assets can you borrow against? Retirement accounts, cars, jewelry, artwork, coin collection, life insurance, or vacation home? List everything you own. You may surprise yourself at what you discover.

Convert Assets to Cash (Downsizing). Rather than borrow against your assets, downsize. Friends of mine sold their 6,000-square-foot Chicago North Shore residence for $1,050,000. With those proceeds they bought a vacation home, a smaller primary residence, and an in-town condominium. In the U.K., they call this popular practice "mouse-holing."

Could you live comfortably in a smaller or less expensive home? Are you wasting money on unproductive luxury cars, jewelry, watches, or clothing? Are you one of the many Americans who live the high life—for now—but fail to build enough wealth to support the twin goals of financial security and financial independence?

In their study of the affluent, Thomas Stanley and William Danko *(The Millionaire Next Door)* interviewed a sample of high-income professionals whom the authors named UAWs (underaccumulators of wealth). They chose a sample of PAWs (prodigious accumulators of wealth)—who worked in less prestigious jobs and earned less income. Because of wise budgeting and investing, the PAWs' net worths far surpassed those of the high-income prodigious spenders. Downsizing now pays big dividends later.

Wraparound Mortgage. A wraparound mortgage helps buyers obtain a high LTV while it provides a seller with a good yield. Investors use wraparounds to gain some benefit from a below-current-market-rate loan that exists against a property—and, yet also obtain a relatively high LTV.

To accomplish these twin goals, the investor "wraps" the existing below-market loan with a new wraparound loan at a higher interest rate. The seller continues to pay the existing low interest rate loan while the buyer pays the seller on the new wraparound loan. The seller profits on the spread in interest rates. The wraparound works best during periods when interest rates shoot up. Figure 2.1 provides an example.

In Figure 2.1, the seller creates and carries a new loan of $210,000 at 9.0 percent. Payments on the seller's existing first mortgage total $1,077 per month. Payments on the new wraparound loan are $1,691 per month. Therefore the seller earns a $614 per month profit. As a return on the $60,000 the seller has left in the deal, he or she earns a return of 12.28 percent ($12 \times 614 \div 60{,}000 = 12.28$). The investor gains because the interest rate charged by the seller falls below the then-prevailing market interest rate on newly originated loans. (If you wrap a "nonassumable" mortgage, the seller's underlying mortgage lender may choose to exercise its "due-on-sale" clause. If that happens, you and the sellers would have to pay off the seller's mortgage and work out some other type of financing. However, during the past 25 years—and especially during periods of high foreclosures, lenders rarely throw their performing loans into default by demanding full payment.)

Use Credit Cards. Although this is one of the more risky techniques of creative finance, some investors take advantage of every credit card offer they receive in the mail. Then when they require quick cash to close a deal, they raise $10,000, $25,000, or even $50,000 from cash advances. Investors sometimes even pay cash for a property with the entire sum raised from credit cards.

Naturally, it makes no sense to use cash advances for long-term financing. On occasion, though, you might find plastic a quick and

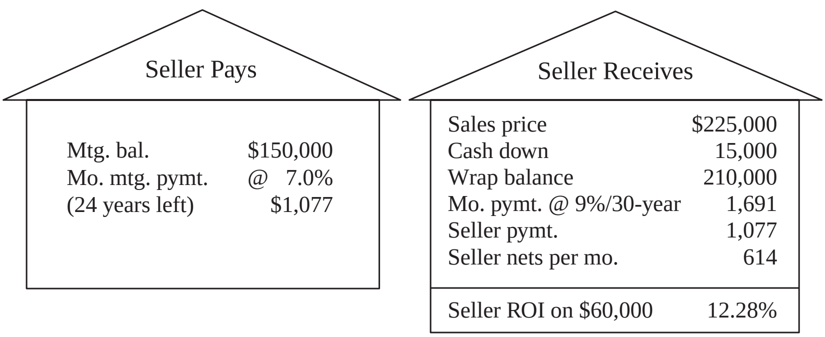

Figure 2.1 Wraparound Loan Example

convenient source to cover short-term needs. For example, you might find a steal of a deal that you can buy (and renovate?), then immediately flip (resell) the property at a profit. For my taste, credit card cash costs too much and generates too much risk. But it's still a possibility– if you clearly calculate that the rewards decisively trump the risks—and you can see multiple unlocked exit doors.

Personal Loans. In the days before credit card cash advances (which are now the most popular type of personal loan), personal loans were called signature loans. As you build your wealth through growing real estate equity, you'll find that many lenders will grant you signature loans—at much lower fees and interest rates than credit card cash advances—in amounts of $10,000, $25,000, $50,000, or even $250,000, if your credit record and net worth can support repayment. Use the money from these signature loans for down payments or renovation funds.

Although mortgage lenders do not favor borrowers who use personal loans for down payments, investors routinely find ways to use this technique. OWC (owner will carry) sellers who finance property sales probably won't inquire (and maybe won't care) about the source of your down payment. If you're short on cash, compare the risks and benefits of using a cash advance or signature loan to raise money for your down payment.

But again, weigh the risk factors. Ill-conceived borrowing can push you into those ugly toss-and-turn, sleepless nights, if not financial ruin. Make sure repayment does not depend on some speculative (uncertain or unpredictable) contingency.

Land Contracts. A land contract—sometimes referred to as a contract for deed, contract of sale, or agreement of sale—permits buyers to pay sellers for their property in installments. Under a land contract, a buyer agrees to buy a property and pay principal and interest to the seller. Unlike mortgage financing, title to the property remains in the seller's name until conditions of the contract are fulfilled. The buyer takes possession of the property. If a buyer defaults on the agreement, the seller can typically repossess (not foreclose on) the property. Sellers favor repossessions because they're quicker, easier, and less costly than foreclosure.

Land contracts may be useful in "wrapping" existing low interest rate financing (see the previous discussion of wraparounds). Caution: These contracts include pitfalls for buyers and sellers. State law governs land contract sales, so consult a competent, local real estate attorney before accepting this form of financing.

Often, properties sold on land contracts are "nonconforming" properties such as storefronts with living quarters in the rear or above, farmhouses with acreage, older properties in need of repair, or larger house that have been split up into multiple apartment units. My first investment was a five-unit property—a large, old house split into four one-bedroom apartments and a one-bedroom, one-bath carriage house that sat on the rear of the lot. I paid $10,000 down, and the seller (an elderly widow) financed the balance at 5 percent interest. She said that was the same rate she could get on a savings account in a bank so she didn't think it would be right to charge more than that. (I would like to find sellers like her today.)

In the present market, land contracts serve the same purposes they always have (nonconforming properties or subpar cash/credit buyers). Yet, as many traditional mortgage lenders reach out to attract more diverse homebuyers and neighborhoods, people and properties that might not have gained lender approval in decades past might now qualify at credit unions, banks, and other types of mortgage companies. In addition, two types of seller-assisted financing have become widespread: lease-purchase and lease-option agreements (see Chapter 9). To some degree, these "rent-to-own" alternatives have substituted for the use of land contracts.

Nevertheless, land contracts can play a role in your property acquisition strategy. Properly written, land contracts are low cost and relatively easy to complete; they offer maximum flexibility in price and interest rate; and they can give sellers quick remedies for borrower default while they protect buyers against unfair forfeiture and future title problems. If you find (or create) a good deal using a land contract, don't pass it up without thoughtful review (and informed legal advice).

Sweat Equity (Create Value through Renovations). You might buy some properties with 100 percent financing if you can enhance their value through improvements and renovations. Say you find a property that should sell (in tip-top condition) for around $240,000. Yet because of its sorry state of repair, as well as an eager seller, you can buy the property at a price of $190,000 with short-term, no-money-down owner financing. You then contribute labor and $15,000 in materials that you pay for with credit cards.

After you complete your work and bring the property up to its $240,000 market value, you arrange a 70 percent LTV mortgage with a lender. With your loan proceeds of $190,000, you pay off the seller and your credit card account. Voilà—you have not only achieved 100 percent financing for your acquisition price and rehab but also created $35,000 of instant equity (wealth).

Use Your Imagination. In addition to the high leverage techniques discussed, here are several others:

- *Bring in partners.* If you can't (or don't want to) draw on your own cash or borrowing power, find a good deal and then show potential money partners (friends, family, contractors, wealthy investors) how they will benefit if they join you in the transaction.

- *Agree to swap services or products.* Would the seller accept some service or expertise that you can provide? Take stock of your skills (law, medicine, dentistry, writing, advertising, carpentry, accounting, landscaping, architecture, etc.). How about products? Say you own a radio station or newspaper. Trade off advertising time or space for a down payment. Anything you can produce, deliver, or sell wholesale (at cost) might work.
- *Borrow (or reduce) the real estate commission.* Most brokers and sales agents generally hate this technique. Still, sometimes buyers and sellers do ask the agents involved in a transaction to defer payment until some later date. A few agents actually prefer to have their commissions in the deal. In doing so, they avoid paying income taxes on these fees, and at the same time they build wealth through interest payments or their receipt of a "piece of the action" (future profits from a sale).
- *Simultaneously sell (or lease) part of the property.* Does the property include an extra lot, a mobile home, or timber, oil, gas, air, or mineral rights? If so, find a buyer who will pay you cash for such rights. In turn, this money will help you close the deal.
- *Prepaid rents and tenant security deposits.* When you buy an income property, you are entitled to the existing tenants' security deposits and prepaid rents. Say you close on June 2. The seller (of a fourplex) is holding $4,000 in tenant security deposits and $3,800 in rent money that applies to the remaining days in June. Together, the deposits and prepaid rents amount to $7,800. In most transactions, you can use these monies to reduce your cash-to-close.
- *Create paper.* You've asked the seller to accept owner financing with 10 percent down. She balks. She believes the deal puts her at risk. Alleviate her fears and bolster her security. Offer her a lien against your car or a second (or third) mortgage on another property you own. Stipulate that when principal payments and property appreciation (added together) lift your equity to 20 percent (LTV of 80 percent), she will remove the security lien she holds against your other pledged asset(s).
- *Lease options.* To discuss creative finance, one must include lease options. And because of their widespread usage, Chapter 9 addresses the pros and cons of this technique.

Are High-Leverage Creative-Finance Deals Really Possible?

Yes, definitely. I have used some type of creative finance (as either buyer or seller) in more than one-half of the property transactions in which I've been involved. To make creative finance work, however, you must know what you are doing. Clearly envision all possible ways the deal might turn against you. Stay calm. Do not become so excited to make the deal that you concede too much. Beware: Low down, creative-finance deals frequently tempt new investors into buying troubled properties or paying excessive prices. Honor commitments—and, just as important, critically affirm that the commitments you make are worth honoring.

Fewer Sellers. Because creative finance violates so-called standard operating procedures, your property choices become fewer. While nearly every seller will accept all cash, smaller numbers are willing to provide financing with little or nothing down.

Nevertheless, look for profit-packed high-leverage creative-finance deals, which are out there. Sellers who first claim they're not interested will soften their attitude once you persuasively explain what's in it for them and then hand them your signed offer.

Lower-Quality, Overpriced Lemons. Keep a sharp eye out for property owners who want to entice you into buying overpriced lemons. These sellers have read the nothing-down books. They know that advertising come-ons like "owner financing," "nothing down," "no qualifying," "make offer," and "EZ terms" will bring dozens of calls from the latest "graduates" of the Ima Guru School of Creative Finance.

Just standing by to fleece the sheep, these sellers surreptitiously lead eager buyers into ill-advised purchase contracts. Maintenance and repair problems, disappearing tenants, phantom leases, illegal units, neighborhood crime, short-term balloon mortgages, troublesome neighbors, and undisclosed liens represent just a few of the setbacks naïve buyers have run into. (For many other types of potential problems, see my book *The 106 Common Mistakes Homebuyers Make (and How to Avoid Them)* (John Wiley & Sons 2008, 4th ed.) In other words, don't let the siren call of creative finance crash your boat into the shoals soon after leaving port.

WHAT UNDERWRITING STANDARDS DO LENDERS APPLY?

To decide whether to grant your request for a mortgage, lenders apply a variety of mortgage underwriting guidelines.[7] The more you can learn

[7] For a more extensive discussion of financing properties, see my book *The 106 Mortgage Secrets That All Homebuyers Must Learn—but Lenders Don't Tell, Second Edition* (John Wiley & Sons, 2008).

about these guidelines, the greater the chance that you'll locate a lender (or seller) who will approve the property financing you want.

In times of cheap and easy money, lenders shovel out money to almost anyone who rolls a wheelbarrow into the bank. In periods of tight money (which always follow periods of loose underwriting), lenders tighten their standards.

1. Collateral (LTV, property characteristics, recourse personal notes)
2. Amount and source of down payment and reserves
3. Capacity (monthly income)
4. Credit history (credibility!)
5. Character and competency
6. Compensating factors

Collateral

Lenders set underwriting standards for *properties* (not just borrowers). Although such standards vary, all lenders specify the types of properties as collateral for their mortgage loans. Some lenders won't finance properties larger than four units. Some won't finance properties in poor condition or those located in run-down neighborhoods. Many lenders verify that a property is serviced by all utilities (e.g., some lenders avoid properties with septic tanks instead of sewer lines). Lenders set standards that apply to paved streets, conformance with zoning and building regulations, and proximity to schools, public transportation, shopping, and job centers.

Before you look at properties and write up an offer to buy, verify whether that property meets the criteria of the lender and loan program that you intend to use. Otherwise you may waste time and money (loan application costs, appraisal, and other miscellaneous fees). Often, lenders will not refund these prepaid expenses.

Loan-to-Value Ratios

As discussed, lenders loan up to a specified percentage of a property's market value (or contract price—whichever is less). After your property meets the lender's feature profile, the lender will order an appraisal.

To calculate loan-to-value requires an independent estimate of value, which, as you learned in Chapter 3,may or may not prove accurate or reasonable.

In good times, appraisers tend to "overappraise." In tough markets, they "underappraise." Thus, as an investor, you face two potential pitfalls: (1) In loose money, the lender may approve a loan that actually exceeds the safe amount you should borrow (without accepting undue risk); and (2) in tough times, the appraisal may come up short. It will either kill your deal or force you to increase the amount of your down payment. To avoid any or all of these underwriting issues, carefully review the lender's appraisal. (See Chapter 3.)

Recourse to Other Assets/Income

In addition to the mortgaged property, lenders might also require you to pledge other assets (property, bank accounts, stocks, etc.) to enhance their security. Indeed, at times you might even offer cross collateralization (or pledged collateral) to a bank in exchange for an LTV that's higher than you might otherwise receive. In close (and sometimes not so close) calls, a boost in the collateral you provide will tip loan approval in your direction.

In addition to collateral, banks (and sellers) will ask property investors to sign a personal note to further guarantee repayment of the monies owed. If you default, such a recourse loan gives the lender (noteholder) the right to go after not just the mortgaged property or other pledged assets, but also, more generally, other assets in which you own an interest or income you are entitled to receive. Odd as it might sound, though, once you advance from smaller properties to larger apartment buildings, offices, and retail centers, lenders typically grant nonrecourse mortgages. The pledged collateral stands as sole security for repayment. In case of payment shortfalls, the lender cannot make a claim against your income or other assets. Other things equal, you should definitely prefer nonrecourse mortgages. When possible, negotiate for a nonrecourse clause in your loan agreements.

Amount and Source of Down Payment and Reserves

Assume that your lender sets a 70 percent LTV for its first mortgage. Plus your seller will carry back a second mortgage for the balance of the purchase price. Will the lender approve your loan application? Maybe; maybe not.

Regardless of LTV, lenders like to see their borrowers put at least some of their own cash into their properties at the time they buy them. Moreover, the lender will probably ask you where you're getting the cash. The best source is ready money from a savings account (or other liquid assets). In contrast, most lenders would not want to hear that you're taking a $10,000 cash advance against your credit card.

Likewise, most lenders want you to retain cash (or liquid assets) after you close your loan. Often, they like to see enough reserves to cover two or three months of mortgage payments. However, the more cash you have available, the better you look.

Capacity (Monthly Income)

As another underwriting guideline, mortgage lenders evaluate your monthly income from employment and other sources, as well as the expected NOI of the property you want to finance. For owner-occupied properties, a lender will (directly or indirectly) emphasize "qualifying ratios." A qualifying ratio is the percentage of your income that you can safely allocate to mortgage payments (principal, interest, property taxes, and insurance, or PITI). If a lender sets a 28 percent housing-cost qualifying ratio and you gross $4,000 a month, the lender may limit your mortgage payments (PITI) to $1,120 a month.

If you are buying your first or second rental house, the lender may count 75 percent of the rents towards your qualifying ratios—but on this point lenders differ. Some will count more and some will count less. Also, for your first few investment property loans, lenders look more to your personal credit and income to support the loan. As you gain investment experience, they become more willing to look at your individual property mortgages on a stand-alone basis. However, the lender will likely still require a personal guarantee from you, thus placing your net worth/earned income as additional backup to the collateral property itself.

For apartment buildings and commercial rental properties, lenders apply a debt coverage ratio (DCR). A debt coverage ratio shows the lender whether the property brings in enough rental income to cover operating expenses and debt service (principal and interest). Here's an example of DCR for a fourplex whose units each rent for $750 a month:

Gross annual income (4 × $750 × 12)	$36,000
less	
Vacancy @ 6% p.a.	$2,160
Operating expenses and upkeep	$7,200
Property taxes and insurance	$2,360
equals	
Net operating income (NOI)	$24,280

If a lender sets a 25 percent margin of net income over debt service, you calculate your maximum allowable mortgage payment by dividing the property's annual NOI by a debt coverage ratio (DCR) of 1.25:

$$\text{NOI/DCR} = \text{Annual mortgage payment}$$
$$\$24{,}280/1.25 = \$19{,}424$$

To check, we reverse the calculations:

$$\text{NOI/Debt Service} = \text{Debt coverage ratio}$$
$$\$24{,}280/\$19{,}424 = 1.25$$

Table 2.1 Monthly Payment Required per $1,000 of Original Mortgage Balance

Interest (%)	Monthly Payment	Interest (%)	Monthly Payment
2.5	$3.95	7.5	$6.99
3.0	4.21	8.0	7.34
3.5	4.49	8.5	7.69
4.0	4.77	9.0	8.05
4.5	5.07	9.5	8.41
5.0	5.37	10.0	8.77
5.5	5.67	10.5	9.15
6.0	5.99	11.0	9.52
6.5	6.32	11.5	9.90
7.0	6.65	12.0	10.29

Note: Terms = 30 years

From these figures, you can see that with a required 1.25 DCR, the property will yield enough income to support a monthly mortgage payment of $1,619 ($19,424 annual mortgage payment ÷ 12). To figure how much loan a mortgage payment of $1,619 a month will pay off (amortize) over a 30-year term, refer to Table 2.1.

At mortgage interest rates of, say, 6.0, 7.5, or 9.0 percent, the lender could loan you up to $270,284, $231,617, or $201,118, respectively.

6.0% Mortgage Interest Rate
$1,619/$5.99 = $270,284 loan amount
7.5% Mortgage Interest Rate
$1,619/$6.99 = $231,617 loan amount
9% Mortgage Interest Rate
$1,619/$8.05 = $201,118 loan amount

Lower interest rates dramatically boost your borrowing power. The interest rate and debt coverage ratio will partially determine how much financing a lender will provide (subject to how well you look vis-á-vis the lender's other underwriting criteria).

Credit History (Credibility!)

Must you produce high credit scores to buy and finance rental houses, condos, and apartment buildings? No, but good credit expands your possibilities. Without a strong credit score, you'll be limited to seller financing, "subject to" loan/purchase agreements, or "B," "C," or "D" loans that carry higher discount points, origination fees, and interest rates (if they are even available). If you show an excellent credit score and credit record, lenders will welcome your business with competitive rates and terms. You become a sought-after customer.

Strengthen your credit score. Satisfy your monthly credit obligations on or before their due dates. Recently, we have heard so much about "lenders making loans tough to get." But for investors who show strong credit scores—say 720 or higher—even troubled lenders have rolled out the red carpet.

Nevertheless, in our highly competitive mortgage market, some mortgage lenders will accept borrowers who have experienced foreclosure, repossession, and bankruptcy. To qualify with these lenders, you typically need (1) to have paid on time, every time for the past 18 to 24 months; (2) to attribute previous adverse credit to divorce, unemployment, accident, illness, or other outside-your-control misfortune; and (3) to persuade the lender that your present and future financial well-being is planted on a firm foundation.

If you've faced serious credit problems in the past, you need not wait 5, 7, or 10 years before a lender will qualify you for a new mortgage—especially if you live in the property you buy. (Remember, lenders provide their easiest qualifying, lowest costs, and best terms for owner occupants.)

Character and Competency

Although U.S. lenders cannot legally underwrite by age, race, religion, sex, marital status, or disability as they evaluate your loan application, they can and do look at other personal characteristics such as the following:

- Education level
- Career advancement potential
- Job stability
- Stability in the community
- Saving, spending, and borrowing habits
- Dependability
- Dress and mannerisms
- Experience in property ownership

A mortgage lender might not arbitrarily reject your loan application because you dropped out of high school, dyed your hair purple, wear a silver nose ring, change jobs every six months, or have not registered a telephone in your own name. Nevertheless, subtle (and not so subtle) influences still count—especially for investors, and especially when tight underwriting prevails.

Property ownership requires commitment. Smart lenders trust you to fulfill your responsibilities. Convince the lender that you are a solid and dependable worker, investor, and borrower. When appropriate, assure the lender via a business plan (or other means) that you'll manage the property to enhance its value.

The legendary banker J. P. Morgan once told a U.S. congressional committee, "Money cannot buy credit. A man I do not trust could not get credit from me on all the bonds of Christendom." J. P. Morgan knows lending: character does count. As "liar's loans" proliferated during 2001–2006, many lenders ignored (to their later regret) J. P.'s sound advice. Although during some future boom period lenders will again lose their common sense, in all loan markets you are wise to play it straight.

Compensating Factors

As you study a lender's underwriting guidelines, remember, these are *guidelines.* Most lenders do not evaluate their mortgage loan applications by inflexible rules. Lenders weigh and consider. You can help persuade a lender to approve your loan. Emphasize your positives and play down or explain away negatives.

If your debt coverage ratio falls below a lender's desired minimum, show the lender how you plan to improve the property and increase rents. If you have accumulated credit problems, compensate with a higher down payment or pledged collateral. If you've frequently changed jobs, point out the raises and promotions you've received. If you lack experience in property ownership or property management, tell the lenders how you've educated yourself by reading real estate books and how you've developed a winning market strategy (see Chapter 11).

Use employer letters, references, prepared budgets, a business plan, or any other *written* evidence that you can come up with to justify your loan request. Anything in writing to persuade the lender that you are willing and able to pay back the money you borrow may help. Compensating factors can make the decision swing in your favor.

Remember, lenders differ—especially when they underwrite investors. What one rejects, another accepts. To get the loan you want, search the mortgage market. With thousands of lenders and loan brokers competing for loans, chances are you can find a lender (or seller) who's right for you. If not, those lenders have just sent you a powerful signal: You must improve your financial fitness and borrower profile.

Automated Underwriting (AUS)

For the past 10 to 15 years, mortgage lenders have relied on automated underwriting. Using such a system, a loan rep gathers pertinent underwriting facts and enters them into a software program.

If your borrower (and property) profile matches the standards written into this loan approval program, great. It means a faster, less costly path to closing, and a shorter stack of paperwork. But if your profile needs outside-the-box attention, work with a savvy loan rep who can apply the skill and knowledge necessary to get your loan approved—or at least tell you the reasons why your application falls short and how you can work to overcome deficiencies.

To see how you might fare with automated underwriting, go to myfico.com. From this site, you can learn your credit scores and obtain pointers on how to improve them.

Automated underwriting (AUS) looks at more than your credit score. These programs incorporate calculations that evaluate your qualifying ratios, earning power, cash reserves, debts, and assets. When your trimerged credit scores exceed, say, 720 (or so), the AUS will loosen up on other standards. Conversely, a score of, say, 640 (or so) will cause the AUS to subject your financial profile to stricter standards and more documentation of income, savings, and other pertinent financial data.

Exactly how AUS programs balance and trade off individual underwriting criteria remains a guarded secret. But savvy loan reps have developed some rule-of-thumb insights. So ask them. Benefit from their experience.

3

APPRAISAL: HOW TO DISCOVER GOOD VALUE

Apply the know-how of Chapter 2, and you will find ways to finance your investment properties. But financing provides only a means to a goal. Your goal is to buy and finance properties that offer strong potential for profit. And to invest *profitably* requires you to estimate (present and future) market value.

Experience shows that many real estate investors (and homebuyers) have glossed over this critical point. Most popular how-to books on real estate investing give short shrift to valuing properties. Why? Because many authors and investors have mistakenly assumed that "inflation cures all mistakes." Naïvely, many investors (speculators) have thought that to make money in real estate, all you have to do is buy it. Even if you pay too much, price increases will eventually bail you out. As example, here's what multimillionaire investor and author, David Schumacher, once advised:

> The amount I paid for this property is inconsequential because of the degree to which it has appreciated [sic: he means increased in price due to inflation and appreciation] in value. . . . In my opinion, it is ridiculous to quibble over $5,000 or even $50,000 in price if you are buying for the long term. . . . In 1963, I bought a four-unit apartment building for $35,000. Suppose I had paid $100,000 for it. It wouldn't have made any difference because the property's worth $1.2 million today. (*The Buy and Hold Real Estate Strategy*, John Wiley & Sons, 1992)[1]

[1] Assuming 20 percent down at 5 percent interest, 30 years, for Schumacher's example property, the monthly payment on $80,000 (assuming a $100,000 purchase

Other top-selling real estate authors advise would-be investors to tell sellers, "You name the price, I'll name the terms." If the property owner agrees to sell on easy terms (usually little or nothing down), the buyer will agree to the seller's price. "Who cares about the price you pay today? What's important is all that money you're going to make when you sell." During the go-go boom years 2001–2006, I witnessed this mistake hundreds of time in places as diverse as Dubai, Dublin, and San Diego.

MAKE MONEY WHEN YOU BUY, NOT JUST WHEN YOU SELL

Long-term price increases (inflation, appreciation) will typically boost a property's eventual selling price. But before you can profit from the long run, you must survive the short run. If you overpay, you may have to wait five years (or more) for the market to catch up.

Even worse, during that wait, negative cash flows (the alligators) may eat you alive. You lose the property. Someone else picks up the same property at a much lower price. Even when investors do struggle through a swampland of alligators, they still miss the rewards they could have obtained if they had chosen a surer and safer route.

Want to profit? Buy right! Long-term successful investors make money when they buy, not just when they sell. You reduce risk and increase your chance for great returns when you buy properties at or (preferably) below their market values. But this tactic requires that you know what the term "market value" really means. (Note: When you buy at a bargain price, you often pay less than market value for a property. However, I also encourage you to buy "undervalued" properties. In this sense, undervalued refers to all properties and/or locations that are loaded with strong potential for gains that may result from a variety of sources. You'll learn how to find and evaluate "undervalued" properties in later chapters.)

WHAT IS MARKET VALUE?

To the uninformed, "appraised value," "sales price," and "market value" all refer to the same concept. In fact, "Appraised value" could refer to an insurance policy appraisal, a property tax appraisal, an estate tax appraisal, *or* a market value appraisal. Sales price itself merely identifies the nominal

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price) would equal $430, whereas a $28,000 loan ($35,000 purchase price) would have required a payment of just $150 a month.

price at which a property has sold. That sales price could equal, exceed, or fall below market value. Market value reliably reflects sales price only when a property is sold according to these five stipulations:

1. Buyers and sellers are typically motivated. Neither acts under duress.
2. Buyers and sellers are well informed about the market and negotiate in their own best interest.

The marketing period and sales promotion efforts are sufficient to bring the property to the attention of willing and able buyers.

3. No atypically favorable or unfavorable terms of financing apply. (During the most recent property boom, lenders offered dangerously easy financing, thus pushing sales prices far above their natural market value.)
4. Neither the sellers nor the buyers offer any extraordinary sales concessions or incentives. (For example, the builders in many countries offered off-plan buyers three years of rent guarantees—clearly a red flag that the builders' prices exceed market value.)

To further illustrate the stipulated conditions underlying the concept of market value, say that two properties recently sold in a neighborhood where you're interested in buying:

Thirty-seven Oak sold at a price of $258,000, and 164 Maple sold at a price of $255,000. Each of these three-bedroom, two-bath houses was in good condition, with around 2,100 square feet. You locate a nearby house of similar size and features at 158 Pine. It's priced at $234,750. Is that a bargain (below market value) price? Maybe; maybe not. Before you draw a conclusion, investigate the terms and conditions of the other two sales.

What if the sellers of 164 Maple had carried back a nothing-down, 5 percent, 30-year mortgage for their buyers (i.e., favorable financing)?

What if the buyers of 37 Oak had just flown into Peoria from San Francisco and bought the first house they saw because "It was such a steal. You couldn't find anything like it in San Francisco for less than $1.2 million" (i.e., uninformed buyers)?

What if the sellers of 37 Oak had agreed to pay all of their buyer's closing costs and leave their authentic Chippendale buffet because it was too big to move into their new condo in Florida (i.e., extraordinary sales concessions)?

Sales Price Doesn't Necessarily Equal Market Value

When you buy real estate, go well beyond merely learning the prices at which other similar properties have sold. Investigate whether the buyers or sellers acted with full market knowledge, gave any unusually favorable (or onerous) terms of financing, bought (or sold) in a hurry, or made concessions that pushed up the nominal selling price—or perhaps pulled it down. If you find that the sales of comparable properties do not meet the conditions of a "market value" sale, weigh that information before you write your contract offer on a property.

In other words, before you rely on comp sales prices to value a property: (1) verify the accuracy of your information; (2) verify the date of sale; and (3) verify the terms and conditions of the sale. Faulty information about a comp property's features or terms of sale can make bad deals look good (or vice versa). Also, market value assumes no hidden defects or title issues. A comp (or subject) house with a termite infestation should sell at a price below market value (see later discussion).

Sound Underwriting Requires Lenders to Loan Only Against Market Value

Financial institutions loan against market value, not purchase price, unless your purchase price falls below market value. When you apply for a mortgage, you may tell the lender that you've agreed to a price of $200,000 and would like to borrow $160,000 (an 80 percent LTV). Yet the lender will not necessarily agree that this price matches the property's market value.

First, the lender will ask about special financing terms (e.g., a $20,000 seller second) and sales concessions (e.g., the seller's plan to buy down your interest rate for three years and pay all closing costs). If your transaction differs from market norms, the lender won't loan 80 percent of your $200,000 purchase price—even if it routinely does make 80 percent LTV loans. The lender may find that easy terms of financing or sales concessions are worth $10,000. So, the lender may calculate your 80 percent LTV ratio against $190,000, not the $200,000 purchase price.

Second, to verify that your purchase price of $200,000 equals or exceeds market value, the lender will order a market value appraisal. If that appraisal report comes back with a figure that's less than $200,000, the lender will use the lesser amount to calculate an 80 percent LTV loan. Take notice: You don't have to passively suffer the results of a low appraisal. Critique the original. Ask the appraiser to correct errors. Or you can ask the lender to order a new appraisal with another firm. The lender needs a file document (appraisal) to justify its lending decision. If you provide an acceptable (revised or remade) appraisal of a satisfactory amount, you'll often get the loan you want.

Danger: Just because a lender's appraiser comes up with a market value estimate that matches your purchase price, never assume that the appraisal accurately sets market value. Accept personal responsibility for your offering price. Loan reps routinely tell their appraisers the value estimate they need to make a deal work. In return, appraisers know that if they fail to "hit the desired numbers," loan reps will select another, more accommodating appraiser to prepare their reports.

If you're a good customer of a bank (or if the bank would like you to become a good customer), the loan rep may encourage the appraiser to issue an MAI (made as instructed) appraisal. I know of many instances where appraisers have acquiesced to not-so-subtle hints from a loan rep and submitted appraisals that overstated a property's value. (Indeed, as early in the property boom as 2003, government investigators found that loan reps were pressuring appraisers to lift their value estimates.)

You will work with appraisers, and you will solicit their opinions, but never accept those opinions as the final word. To protect yourself against inaccurate appraisals (your own, as well as others), understand how to calculate, apply, and interpret the three technical methods used to estimate market value.

HOW TO ESTIMATE MARKET VALUE

Investors, lenders, and appraisers rely on three techniques to value properties.

1. *Cost approach.* (1) Calculate how much it would cost to build a subject property at today's prices, (2) subtract accrued depreciation, and (3) add the depreciated cost figure to the current value of the lot.
2. *Comparable sales approach.* (1) Compare a subject property with other similar (comp) properties that have recently sold, (2) adjust the prices for each positive or negative feature of the comps relative to the subject property, (3) via this detailed and systematic comparison, adjust for positive and negative property differences, and (4) estimate market value of the subject property from the adjusted sales prices of the comps.
3. *Income approach.* (1) Estimate the rents you expect a property to produce, and (2) convert net rents after expenses (net operating income) into a capital (market) value amount.

You evaluate a property from three perspectives to check the value estimates of each against the others. Multiple estimates and techniques enhance the probability that your estimate reflects reality. If your three value estimates don't reasonably match up, either your calculations err, the figures you're working with are inaccurate, or the market is acting "crazy" and property prices are about to head up (or down).

Figure 3.1 shows a sample appraisal form for a single-family house. Refer to this form as you read the following pages and you'll see how to apply these three techniques to appraise properties. Photocopy this form (or print a copy from the Internet). Use the forms to fill in property and market information as you value potential property investments.

PROPERTY DESCRIPTION

To accurately estimate the value of a property, first describe the features of the property and its neighborhood in detail. List all facts that might influence value favorably or unfavorably. Investors err in their appraisals because they casually inspect rather than carefully detail and compare. Focus on each of the neighborhood and property features listed on an appraisal form. You will value properties more profitably.

Identify the Subject Property

To identify the subject property seems straightforward. Nevertheless, you might experience some pitfalls. For example, the street address for one of my previous homes was 73 Roble Road, Berkeley, California 94705. However, that property does not sit in Berkeley. It is actually located in Oakland. The house sat back from Roble Road (which is in Berkeley) about 100 feet—just far enough to put it within the city limits of Oakland. As a result, the city laws governing the property (zoning, building regulations, permits, rent controls, school district, etc.) were those of Oakland, not Berkeley.

Similarly, Park Cities (University Park and Highland Park) are high-income, independent municipalities located within the geographic boundaries of Dallas, Texas. Among other amenities, Park Cities are noted for their high-quality schools. Yet (in the past) if you lived in Park Cities on the west side of the North Dallas Tollway, your children would attend the lesser-regarded schools of the Dallas Independent School District.

The lesson: Street and city addresses don't always tell you what you need to know about a property. Strange as it may seem, a property may not be located where you think it is. (See also forthcoming discussion of site identification.)

Neighborhood

As the appraisal form shows, a neighborhood investigation should note the types and condition of neighborhood properties, the percentage of houses

Uniform Residential Appraisal Report

File #

The purpose of this summary appraisal report is to provide the lender/client with an accurate, and adequately supported, opinion of the market value of the subject property.

SUBJECT

Property Address | City | State | Zip Code

Borrower | Owner of Public Record | County

Legal Description

Assessor's Parcel # | Tax Year | R.E. Taxes $

Neighborhood Name | Map Reference | Census Tract

Occupant ☐ Owner ☐ Tenant ☐ Vacant | Special Assessments $ | ☐ PUD | HOA $ | ☐ per year ☐ per month

Property Rights Appraised ☐ Fee Simple ☐ Leasehold ☐ Other (describe)

Assignment Type ☐ Purchase Transaction ☐ Refinance Transaction ☐ Other (describe)

Lender/Client | Address

Is the subject property currently offered for sale or has it been offered for sale in the twelve months prior to the effective date of this appraisal? ☐ Yes ☐ No

Report data source(s) used, offering price(s), and date(s).

CONTRACT

I ☐ did ☐ did not analyze the contract for sale for the subject purchase transaction. Explain the results of the analysis of the contract for sale or why the analysis was not performed.

Contract Price $ | Date of Contract | Is the property seller the owner of public record? ☐Yes ☐No | Data Source(s)

Is there any financial assistance (loan charges, sale concessions, gift or downpayment assistance, etc.) to be paid by any part y on behalf of the borrower? ☐ Yes ☐ No

If Yes, report the total dollar amount and describe the items to be paid.

NEIGHBORHOOD

Note: Race and the racial composition of the neighborhood are not appraisal factors.

Neighborhood Characteristics	One-Unit Housing Trends	One-Unit Housing		Present Land Use %	
Location ☐ Urban ☐ Suburban ☐ Rural	Property Values ☐ Increasing ☐ Stable ☐ Declining	PRICE	AGE	One-Unit	%
Built-Up ☐ Over 75% ☐ 25–75% ☐ Under 25%	Demand/Supply ☐ Shortage ☐ In Balance ☐ Over Supply	$ (000)	(yrs)	2-4 Unit	%
Growth ☐ Rapid ☐ Stable ☐ Slow	Marketing Time ☐ Under 3 mths ☐ 3–6 mths ☐ Over 6 mths	Low		Multi-Family	%
Neighborhood Boundaries		High		Commercial	%
		Pred.		Other	%

Neighborhood Description

Market Conditions (including support for the above conclusions)

SITE

Dimensions | Area | Shape | View

Specific Zoning Classification | Zoning Description

Zoning Compliance ☐ Legal ☐ Legal Nonconforming (Grandfathered Use) ☐ No Zoning ☐ Illegal (describe)

Is the highest and best use of the subject property as improved (or as proposed per plans and specifications) the present use? ☐ Yes ☐ No If No, describe

Utilities	Public	Other (describe)		Public	Other (describe)	Off-site Improvements—Type	Public	Private
Electricity	☐	☐	Water	☐	☐	Street	☐	☐
Gas	☐	☐	Sanitary Sewer	☐	☐	Alley	☐	☐

FEMA Special Flood Hazard Area ☐ Yes ☐ No | FEMA Flood Zone | FEMA Map # | FEMA Map Date

Are the utilities and off-site improvements typical for the market area? ☐ Yes ☐ No If No, describe

Are there any adverse site conditions or external factors (easements, encroachments, environmental conditions, land uses, etc.)? ☐ Yes ☐ No If Yes, describe

IMPROVEMENTS

General Description	Foundation	Exterior Description materials/condition	Interior materials/condition
Units ☐ One ☐ One with Accessory Unit	☐ Concrete Slab ☐ Crawl Space	Foundation Walls	Floors
# of Stories	☐ Full Basement ☐ Partial Basement	Exterior Walls	Walls
Type ☐ Det. ☐ Att. ☐ S-Det./End Unit	Basement Area sq. ft.	Roof Surface	Trim/Finish
☐ Existing ☐ Proposed ☐ Under Const.	Basement Finish %	Gutters & Downspouts	Bath Floor
Design (Style)	☐ Outside Entry/Exit ☐ Sump Pump	Window Type	Bath Wainscot
Year Built	Evidence of ☐ Infestation	Storm Sash/Insulated	Car Storage ☐ None
Effective Age (Yrs)	☐ Dampness ☐ Settlement	Screens	☐ Driveway # of Cars
Attic ☐ None	Heating ☐ FWA ☐ HWBB ☐ Radiant	Amenities ☐ Woodstove(s) #	Driveway Surface
☐ Drop Stair ☐ Stairs	☐ Other Fuel	☐ Fireplace(s) # ☐ Fence	☐ Garage # of Cars
☐ Floor ☐ Scuttle	Cooling ☐ Central Air Conditioning	☐ Patio/Deck ☐ Porch	☐ Carport # of Cars
☐ Finished ☐ Heated	☐ Individual ☐ Other	☐ Pool ☐ Other	☐ Att. ☐ Det. ☐ Built-in

Appliances ☐Refrigerator ☐Range/Oven ☐ Dishwasher ☐ Disposal ☐ Microwave ☐ Washer/Dryer ☐ Other (describe)

Finished area **above** grade contains: Rooms | Bedrooms | Bath(s) | Square Feet of Gross Living Area Above Grade

Additional features (special energy efficient items, etc.)

Describe the condition of the property (including needed repairs, deterioration, renovations, remodeling, etc.).

Are there any physical deficiencies or adverse conditions that affect the livability, soundness, or structural integrity of the property? ☐ Yes ☐ No If Yes, describe

Does the property generally conform to the neighborhood (functional utility, style, condition, use, construction, etc.)? ☐ Yes ☐ No If No, describe

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Figure 3.1 Appraisal Report

Uniform Residential Appraisal Report

File #

There are comparable properties currently offered for sale in the subject neighborhood ranging in price from $ to $.

There are comparable sales in the subject neighborhood within the past twelve months ranging in sale price from $ to $.

SALES COMPARISON APPROACH

FEATURE	SUBJECT	COMPARABLE SALE # 1		COMPARABLE SALE # 2		COMPARABLE SALE # 3	
Address							
Proximity to Subject							
Sale Price	$		$		$		$
Sale Price/Gross Liv. Area	$ sq. ft.	$ sq. ft.		$ sq. ft.		$ sq. ft.	
Data Source(s)							
Verification Source(s)							
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+(-) $ Adjustment	DESCRIPTION	+(-) $ Adjustment	DESCRIPTION	+(-) $ Adjustment
Sale or Financing Concessions							
Date of Sale/Time							
Location							
Leasehold/Fee Simple							
Site							
View							
Design (Style)							
Quality of Construction							
Actual Age							
Condition							
Above Grade	Total Bdrms. Baths	Total Bdrms. Baths		Total Bdrms. Baths		Total Bdrms. Baths	
Room Count							
Gross Living Area	sq. ft.	sq. ft.		sq. ft.		sq. ft.	
Basement & Finished Rooms Below Grade							
Functional Utility							
Heating/Cooling							
Energy Efficient Items							
Garage/Carport							
Porch/Patio/Deck							
Net Adjustment (Total)		☐ + ☐ -	$	☐ + ☐ -	$	☐ + ☐ -	$
Adjusted Sale Price of Comparables		Net Adj. % Gross Adj. %	$	Net Adj. % Gross Adj. %	$	Net Adj. % Gross Adj. %	$

I ☐ did ☐ did not research the sale or transfer history of the subject property and comparable sales. If not, explain

My research ☐ did ☐ did not reveal any prior sales or transfers of the subject property for the three years prior to the effective date of this appraisal.

Data source(s)

My research ☐ did ☐ did not reveal any prior sales or transfers of the comparable sales for the year prior to the date of sale of the comparable sale.

Data source(s)

Report the results of the research and analysis of the prior sale or transfer history of the subject property and comparable sales (report additional prior sales on page 3).

ITEM	SUBJECT	COMPARABLE SALE # 1	COMPARABLE SALE # 2	COMPARABLE SALE # 3
Date of Prior Sale/Transfer				
Price of Prior Sale/Transfer				
Data Source(s)				
Effective Date of Data Source(s)				

Analysis of prior sale or transfer history of the subject property and comparable sales

Summary of Sales Comparison Approach

Indicated Value by Sales Comparison Approach $

Indicated Value by: Sales Comparison Approach $ Cost Approach (if developed) $ Income Approach (if developed) $

This appraisal is made ☐ "as is", ☐ subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, ☐ subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or ☐ subject to the following required inspection based on the extraordinary assumption that the condition or deficiency does not require alteration or repair:

Based on a complete visual inspection of the interior and exterior areas of the subject property, defined scope of work, statement of assumptions and limiting conditions, and appraiser's certification, my (our) opinion of the market value, as defined, of the real property that is the subject of this report is $, as of , which is the date of inspection and the effective date of this appraisal.

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Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

ADDITIONAL COMMENTS

COST APPROACH

COST APPROACH TO VALUE (not required by Fannie Mae)

Provide adequate information for the lender/client to replicate the below cost figures and calculations.

Support for the opinion of site value (summary of comparable land sales or other methods for estimating site value)

ESTIMATED ☐ REPRODUCTION OR ☐ REPLACEMENT COST NEW	OPINION OF SITE VALUE..= $			
Source of cost data	Dwelling	Sq. Ft. @ $		.....................=$
Quality rating from cost service Effective date of cost data		Sq. Ft. @ $		.....................=$
Comments on Cost Approach (gross living area calculations, depreciation, etc.)				
	Garage/Carport Sq. Ft. @ $			.....................=$
	Total Estimate of Cost-New			....................= $
	Less Physical	Functional	External	
	Depreciation			=$( )
	Depreciated Cost of Improvements..=$			
	"As-is" Value of Site Improvements..=$			
Estimated Remaining Economic Life (HUD and VA only) Years	Indicated Value By Cost Approach.................................... ....=$			

INCOME

INCOME APPROACH TO VALUE (not required by Fannie Mae)

Estimated Monthly Market Rent $ X Gross Rent Multiplier = $ Indicated Value by Income Approach

Summary of Income Approach (including support for market rent and GRM)

PUD INFORMATION

PROJECT INFORMATION FOR PUDs (if applicable)

Is the developer/builder in control of the Homeowners' Association (HOA)? ☐ Yes ☐ No Unit type(s) ☐ Detached ☐ Attached

Provide the following information for PUDs ONLY if the developer/builder is in control of the HOA and the subject property is an attached dwelling unit.

Legal name of project

Total number of phases Total number of units Total number of units sold

Total number of units rented Total number of units for sale Data source(s)

Was the project created by the conversion of an existing building(s) into a PUD? ☐ Yes ☐ No If Yes, date of conversion

Does the project contain any multi-dwelling units? ☐ Yes ☐ No Data source(s)

Are the units, common elements, and recreation facilities complete? ☐ Yes ☐ No If No, describe the status of completion.

Are the common elements leased to or by the Homeowners' Association? ☐ Yes ☐ No If Yes, describe the rental terms and options.

Describe common elements and recreational facilities

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Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

This report form is designed to report an appraisal of a one-unit property or a one-unit property with an accessory unit; including a unit in a planned unit development (PUD). This report form is not designed to report an appraisal of a manufactured home or a unit in a condominium or cooperative project.

This appraisal report is subject to the following scope of work, intended use, intended user, definition of market value, statement of assumptions and limiting conditions, and certifications. Modifications, additions, or deletions to the intended use, intended user, definition of market value, or assumptions and limiting conditions are not permitted. The appraiser may expand the scope of work to include any additional research or analysis necessary based on the complexity of this appraisal assignment. Modifications or deletions to the certifications are also not permitted. However, additional certifications that do not constitute material alterations to this appraisal report, such as those required by law or those related to the appraiser's continuing education or membership in an appraisal organization, are permitted.

SCOPE OF WORK: The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

INTENDED USE: The intended use of this appraisal report is for the lender/client to evaluate the property that is the subject of this appraisal for a mortgage finance transaction.

INTENDED USER: The intended user of this appraisal report is the lender/client.

DEFINITION OF MARKET VALUE: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

STATEMENT OF ASSUMPTIONS AND LIMITING CONDITIONS: The appraiser's certification in this report is subject to the following assumptions and limiting conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it, except for information that he or she became aware of during the research involved in performing this appraisal. The appraiser assumes that the title is good and marketable and will not render any opinions about the title.

2. The appraiser has provided a sketch in this appraisal report to show the approximate dimensions of the improvements. The sketch is included only to assist the reader in visualizing the property and understanding the appraiser's determination of its size.

3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in this appraisal report whether any portion of the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.

4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand, or as otherwise required by law.

5. The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing this appraisal. Unless otherwise stated in this appraisal report, the appraiser has no knowledge of any hidden or unapparent physical deficiencies or adverse conditions of the property (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) that would make the property less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, this appraisal report must not be considered as an environmental assessment of the property.

6. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that the completion, repairs, or alterations of the subject property will be performed in a professional manner.

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Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

APPRAISER'S CERTIFICATION: The Appraiser certifies and agrees that:

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.

2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.

3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

4. I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.

5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.

6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.

7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.

8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.

9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.

10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.

11. I have knowledge and experience in appraising this type of property in this market area.

12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located .

13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.

14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.

15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.

16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.

17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.

18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).

19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.

20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.

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Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

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21. The lender/client may disclose or distribute this appraisal report to: the borrower; another lender at the request of the borrower; the mortgagee or its successors and assigns; mortgage insurers; government sponsored enterprises; other secondary market participants; data collection or reporting services; professional appraisal organizations; any department, agency, or instrumentality of the United States; and any state, the District of Columbia, or other jurisdictions; without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).

22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.

23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.

24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws.

SUPERVISORY APPRAISER'S CERTIFICATION: The Supervisory Appraiser certifies and agrees that:

1. I directly supervised the appraiser for this appraisal assignment, have read the appraisal report, and agree with the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

2. I accept full responsibility for the contents of this appraisal report including, but not limited to, the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

3. The appraiser identified in this appraisal report is either a sub-contractor or an employee of the supervisory appraiser (or the appraisal firm), is qualified to perform this appraisal, and is acceptable to perform this appraisal under the applicable state law.

4. This appraisal report complies with the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

5. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

APPRAISER

Signature____
Name____
Company Name____
Company Address_______________________________________
____
Telephone Number_______________________________________
Email Address____
Date of Signature and Report______________________________
Effective Date of Appraisal________________________________
State Certification #_____________________________________
or State License #____
or Other (describe)_________________State #_____________
State____
Expiration Date of Certification or License____________________

ADDRESS OF PROPERTY APPRAISED
____
____

APPRAISED VALUE OF SUBJECT PROPERTY $_____________

LENDER/CLIENT
Name____
Company Name____
Company Address_______________________________________
____
Email Address____

SUPERVISORY APPRAISER (ONLY IF REQUIRED)

Signature____
Name____
Company Name____
Company Address_______________________________________
____
Telephone Number_______________________________________
Email Address____
Date of Signature_______________________________________
State Certification #_____________________________________
or State License #____
State____
Expiration Date of Certification or License_________________

SUBJECT PROPERTY

☐ Did not inspect subject property
☐ Did inspect exterior of subject property from street
Date of Inspection_________________________________
☐ Did inspect interior and exterior of subject property
Date of Inspection_________________________________

COMPARABLE SALES

☐ Did not inspect exterior of comparable sales from street
☐ Did inspect exterior of comparable sales from street
Date of Inspection_________________________________

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Figure 3.1 (*Continued*)

and condominiums that are owner occupied, vacancy rates, property price (and rental) ranges, the types and quality of government services, and the relative convenience of the property to shopping, schools, employment centers, parks and recreational areas—the appeal of the neighborhood to potential buyers.

Next, imagine the future. Envision the changes that are likely to occur in the neighborhood during the coming three to five years. Is the neighborhood stable? Is it moving toward higher rates of owner occupancy? Are property owners fixing up their properties? Do neighborhood residents and local merchants take pride in their properties and the surrounding area? Is a neighborhood (or homeowners') association working to improve the area? If not, could such an association make the neighborhood a better place to live, shop, work, and play?

When you invest in property, you buy the future even more than the present. View the neighborhood with both a crystal ball as well as a magnifying glass. Visualize how the neighborhood will (or could be made to) look, feel, and live five years into the future.

Site (Lot) Characteristics

Depending on the neighborhood, the size and features of a lot can account for 20 to 80 percent of a property's current and future value. Smart investors pay as much attention to the lot (and its potential) as they do to the building(s).

In addition to site size and features (see appraisal form), review the rules and restrictions that govern a site. Determine whether the buildings conform to zoning, occupancy, environmental, and safety regulations. Many two- to four-unit (and larger) properties have been modified (rehabbed, cut up, added to, repaired, renovated, rewired, reroofed, etc.) in ways that violate current law. Of course, laws change. Even if the property did conform, it may now violate today's legal standards.

Land use law classifies properties as (1) legal and conforming, (2) legal and nonconforming, and (3) illegal. When a property meets all of today's legal standards, it's called legal and conforming. If it met past standards that don't meet current law, but have been "grandfathered," the property qualifies as legal but nonconforming.

If the property includes features or uses that violate standards not grandfathered as permissible, those features or uses remain illegal. Even work that conforms to the law might place the owner in jeopardy if such work was performed without a valid permit.

If you buy a property that fails to meet current law, buy with your eyes open. Lower your offering price to reflect risk. At some future time, inspectors may require you to bring the property up to code. Just as important, health, safety, and environmental violations may:

- ♦ Subject your tenants to injury
- ♦ Motivate a rent strike
- ♦ Expose you to a lawsuit
- ♦ Expose you to civil or criminal penalties (fines, and in serious cases, prison)

Before you decide upon the price to pay for a property, verify code compliance. To bring a nonconforming property up to code (or to tear out and reinstall unpermitted work) can cost thousands (or even tens of thousands) of dollars.

Improvements

After you investigate the legal restrictions relative to site size, features, and improvements (e.g., parking, driveways, fencing, landscaping, utilities, sewage disposal), detail the size, condition, quality, and appeal of the house or apartment units located on the site. Building size itself ranks as one of the most important determinants of value. To determine size (room count, square footage) requires more than mere counting or pulling out a tape measure.

As you inspect properties, you'll see converted basements, garages, and attics; you'll see heated/cooled and unheated/uncooled living areas; you'll see "bedrooms" without closets and "dining areas" without space for a family-size table and chairs, let alone a buffet or china cabinet; you'll see rooms with 6-foot ceilings or lower, and rooms with 12-foot ceilings or higher; you'll see some storage areas that users can access easily and others that you can reach only by crawling on your hands and knees or standing on a ladder. You'll see decks, patios, and porches that display uniquely strange designs.

In sum, you'll see that all space is not created equal. Go beyond comparisons of size, purported space use, or room count. Judge the quality, livability, traffic patterns, and storage areas within the property.

Even more challenging, not everyone measures square footage in the same way: A builder recently asked five appraisers to measure one of his new homes. In sales promotion literature, the builder listed the home as 3,103 square feet. One appraiser came up with a square-footage count of 3,047 square feet. The other appraisers came up with measures that ranged between 2,704 square feet and 3,312 square feet. Differences such as these occur not just from mistakes but because no "square-footage police" prescribe or enforce measurement methods.

When you read or hear a property's room count or size, do not blindly trust that information. Judge the quality, size, and desirability of the space. Here's another example. I once owned a lakefront house with a large master bedroom (MBR) that faced the lake through a full wall-sized window. In valuing that house, an appraiser rated as equivalent another lakefront home—only its MBR was much smaller and faced street-side.

In his report, the appraiser made no note of that huge difference (as perceived by most would-be buyers). To compound his errors, the appraiser also rated the "lakefront" lots equivalent—even though one (mine) was 40,000 square feet with 165 feet of frontage versus the "comp" site at 20,000 square feet with 100 feet of lake frontage. Never accept—without verification—an appraiser's comp data or feature adjustments.

THE COST APPROACH

The cost approach recognizes that you can either build (or buy) a new property or buy an existing one. Replacement cost typically sets the upper limit to the price you would pay for an existing property. If you can build a new property for $380,000 (including the cost of a lot), then why pay $380,000 for a like-kind existing property located just down the street? In fact, why even pay $380,000 for that older property? It suffers (at least some) deterioration.

Calculate Cost to Build New

To follow the logic of the cost approach, refer to the appraisal form. First, calculate the cost to build the property using dollars per square foot. Use a figure that would apply in your area for the type of property you're valuing. To learn these per-square-foot costs, talk with local contractors or consult the Marshall & Swift construction cost manuals in the reference section of your local library or on the Internet.

Because replacement costs correlate directly with the size and quality of buildings, accurate measurement precedes accurate valuation. Notice, too, that you add the expense of upgrades and extras (crystal chandelier, high-grade wall-to-wall carpeting, Italian tile, granite countertops, high-end appliances or plumbing fixtures, sauna, hot tub, swimming pool, garage, carport, patios, porches, etc.) to the cost of the basic construction.

Deduct Depreciation

After you calculate today's building costs for the subject property, deduct three types of depreciation: (1) physical, (2) functional, and (3) external.

As a building ages, it becomes less valuable than new construction because of *physical* depreciation (wear and tear): The property is exposed to time, weather, use, and abuse; it deteriorates. Frayed carpets, faded paint, cracked plaster, rusty plumbing, and leaky roofs bring down a property's value when compared with new construction. Exactly how much remains your call. To fill in a physical depreciation figure for a building in good condition, estimate, say, 10 percent or 20 percent; if the property appears run-down, you might justify 50 percent depreciation or greater. Or instead of applying a percentage depreciation figure, itemize the costs of the repairs and renovations that would restore the property to like-new condition.

Itemized repairs do not work as well as percentage estimates, because you can't economically upgrade an eight-year-old roof, four-year-old carpeting, or a nine-year-old furnace to like-new condition. Nevertheless, in one way or another, figure how much you think the subject property has depreciated relative to a newly built property of the same size, quality, and features.

Next, estimate the amount of *functional* depreciation. Unlike wear and tear, which occurs naturally through use and abuse, functional depreciation creates loss of value due to undesirable features such as outdated dark wood paneling, a faulty floor plan, low-amperage electrical systems, out-of-favor color schemes, or weirdly unique architectural design. A property may show little physical depreciation but still suffer large functional obsolescence. The features of the property just do not appeal to potential buyers or renters.

External (locational) depreciation occurs when a property fails to reflect the highest and best use for a site. You find a small, well kept house located in an area now dotted with offices and retail stores. Zoning of the site has changed. More than likely, the house (as a house, per se) may not add much to the site's value. The investor who buys the "house" would likely tear it down or renovate it and create a retail store or office building.

For such duck-out-of-water properties, external (locational) factors make the buildings obsolete. External depreciation can approach 100 percent. With or without the building, the site should sell at approximately the same price. This principle also applies when neighborhoods move upscale, and well-kept three-bedroom, two-bath houses of 1,600 square feet are torn down and replaced with 5,000-square-foot McMansions. Investors and builders refer to these smaller existing houses as *teardowns*—even though their owners may have lovingly maintained them.

Lot Value

To estimate lot value, find similarly zoned (vacant) lots that have recently sold, or lots that have sold with teardowns on them. When you compare sites, note all features such as size, frontage, views, topography, legal restrictions, subdivision rules, and other features that can affect the values of the respective sites.

Estimate Market Value (Cost Approach)

As you can see on the appraisal form, after you've completed the steps discussed (calculate a property's construction cost as if newly built, deduct depreciation, and add in site value), you have computed market value. Because you can't precisely measure construction costs, depreciation, or site value, the cost approach won't give you a perfect answer (of course, neither do the comp sale or income approaches—reason and judgment rule). But the cost approach will provide a reference point to use with the comp sales and income approaches. Here's a simple example of the cost approach:

Property description: Six-year-old, good-condition, single-family house of 2,200 square feet. The house includes a two-car, 500-square-foot garage, a deck, in-ground pool, sprinkler system, and premium carpets, appliances, and kitchen cabinets. Nearby vacant lots have recently sold for $60,000.

Dwelling (2,200 × $108 per-square-foot base construction costs)	$237,600
Upgrades	13,500
Deck, lap pool, sprinklers	21,750
Garage (500 × $33 per square foot)	16,500
Total	$289,350
Less	
Physical depreciation at 10%	(28,935)
Functional depreciation at 5%	(14,438)
Depreciated building value	$245,978
Site improvements (sidewalks, driveway, fencing, landscaping)	18,750
Lot value	60,000
Equals	
Indicated market value, cost approach	$324,728

Typically builders build only when they think they can construct properties that will sell (or rent) to yield enough revenue to cover their construction costs and desired profit margin. Therefore, you can usually expect sales prices to go up when construction costs significantly exceed the market values of new properties. Why? Because without expected profit, builders stop building. When growing demand begins to push against a scarce supply, eventually builder profits return. The real estate construction cycle starts anew. The opposite also applies. When builder profits fatten, sooner or later, they overbuild. High expected profits lead to a surplus of new construction. Too much housing inventory brings down market values for new as well as existing properties.

Did I hear someone say Las Vegas, Miami, coastal Spain, or Dubai? Easy financing encouraged buyers to pay prices that (temporarily) supported inflated builder profit margins. Builders overbuilt. Buyers overleveraged and overpaid. Together they lit the torch for the current market meltdown.

Investors rejoice. Overbuilding leads to underbuilding. During the recent downturn, new housing starts nosedived to fewer than 400,000 units—down from 1,600,000 units in 2006. Only large price gains will bring builders back into the game. Until market values significantly increase, homebuilders will not build many new houses. As new supply remains depressed—and as inventories of foreclosures and REOs are worked down—the market generates the conditions to support the next cyclical upswing.

THE COMPARABLE SALES APPROACH

For houses, condominiums, co-ops, townhouses, and apartment buildings, the comparable sales approach generally provides the most accurate estimate of market value. If you want to know the probable price at which a specific property will sell, find out the recent selling prices, terms of sale, and physical features of similar properties.

As explained later, investors rely on the income approach to value apartment buildings, shopping centers, and offices. However, to apply the income approach requires good comp sales. The income approach does not stand independent of the market.

Select Comparable Properties

The accuracy of the comparable sales approach depends on your ability to find recently sold properties that closely match a subject property. Ideally, find comp sales in neighborhoods or developments that resemble each other in property size, age, features, condition, quality of construction, room count, and floor plan. As a practical matter, you seldom find perfect comp matches because each property, each location, displays unique characteristics.

Nevertheless, you don't need a perfect match. When you find comp sales that reasonably match a subject property, you ballpark a value estimate by comparing price per square foot of living area.

Assume that you research three comp sales: (Comp 1) 1,680 square feet, (Comp 2) 1,840 square feet, and (Comp 3) 1,730 square feet. These properties sold recently for the respective prices of $225,120, $213,440, and $211,060. To figure the selling price per square foot of living area for these homes, divide the sales price of each house by its total square footage.

Comp 1
$225,120/1,680 = $134

Comp 2
$213,440/1,840 = $116

Comp 3
$211,060/1,730 = $122

If the house you're interested in has 1,796 square feet of living area, it will probably sell in the range of $120 to $130 per square foot, or $215,520 to $233,480.

Approximate Value Range—Subject Property

$120 × 1,796 = $215,520
$130 × 1,796 = $233,480

Sales price per square foot helps ballpark your value estimate. To gain deeper insight, compare and contrast similar properties to your subject property on a feature-by-feature basis.

Adjust for Differences

After you, your real estate agent, or an appraiser finds appropriate comparables, adjust the comp sales prices up or down to compensate for the features that appear inferior or superior to a subject property. Here's a brief example of this adjustment process:

Adjustment Process (Selected Features)

	Comp 1	Comp 2	Comp 3
Sales price	$225,120	$213,440	$211,060
Features			
Sales concessions	0	−10,000	0
Financing concessions	−15,000	0	0
Date of sale	0	10,000	0
Location	0	0	−20,000
Floor plan	0	5,000	0
Garage	11,000	0	17,000
Pool, patio, deck	−9,000	−13,000	0
Indicated value of subject	$212,120	$205,440	$208,060

As you adjust the selling prices of similar houses to reflect their differences as per the subject property, you move toward your best estimate of the market value range for the subject property. Although our preliminary price-per-square-foot estimated market value for the subject to be worth between $215,520 and $233,480, after adjustments, a price range between $212,120 and $205,440 seems reasonable.

Explain the Adjustments

To adjust for differences in size, quality, or features, you equalize a subject property and each of its comparables: "At what price would the comparable have sold if it *exactly* matched the subject property?" For example, consider the $15,000 adjustment to Comp 1 for financing concessions.

In this sale, the sellers carried back a 90 percent LTV mortgage (10 percent down) on the property at an interest rate of 6.5 percent. At the time, investor financing usually required a 75 percent LTV (25 percent down) and a 7.75 percent interest rate. Without this favorable owner financing, Comp 1 would probably have sold for $15,000 less than its actual sales price of $225,120. Because the definition of market value assumes financing on terms typically available in the market, the premium created by this OWC (owner will carry) financing is subtracted from Comp 1's actual selling price. Here are the explanations for other adjustments:

Comp 1 garage at (+) $11,000. The subject property stands superior with its oversize double-car garage, whereas Comp 1 has only a single-car garage. With a larger garage like the subject's, Comp 1 would have brought an $11,000 higher sales price.

Comp 1 pool, patio, and deck at (–) $9,000. Comp 1 is superior to the subject property on this feature because the subject lacks a deck and tile patio. Without this feature, Comp 1 would have sold for $9,000 less.

Comp 2 sales concession at (–) $10,000. The $213,440 sales price in this transaction included the seller's custom-made drapes, a washer and dryer, and a backyard storage shed. Because these items aren't customary in this market, the sales price is adjusted downward to equalize this feature with the subject property, whose sale will not include these items.

Comp 2 floor plan at (+) $5,000. Unlike the subject property, Comp 2 lacked convenient access from the garage to the kitchen. The garage was built under the house; residents must carry groceries up an outside stairway to enter the kitchen. With more conventional and convenient access, the selling price of Comp 2 would probably have increased by $5,000.

Comp 3 location at (–) $20,000. Comp 3 was located on a cul-de-sac, and its backyard bordered an environmentally protected wooded area. In contrast, the subject property sits on a typical subdivision street, and its rear yard abuts that of a neighbor. Because of its less-favorable location, the subject property could be expected to sell for $20,000 less than Comp 3.

At this point, you may be asking, "How can I or anyone else come up with the specific dollar amounts for each of these adjustments?" To that question, there's no easy answer. You accrue such knowledge by talking with sales agents and tracking sales transactions over a period of months and even years.

Nevertheless, even without experience, you still can weigh the opinions of others against your own judgment. Ask questions. Explore their reasoning. Verify their facts. As you look at properties, discipline your mind to list and detail all features that make a difference. Before you attach adjustment numbers to each property's unique features, first observe those differences.

THE INCOME APPROACH

Near the bottom of page 3 of the appraisal form, you can see a line labeled "Indicated Value by Income Approach (If Applicable)." As shown there, the income approach refers to an appraisal technique called the gross rent multiplier (GRM).

To calculate market value using the GRM, find the monthly rents and sales prices of similar houses or apartment buildings. For example, through market research, you discover the following rental houses: (1) 214 Jackson rents for $1,045 a month and sold for $148,200; (2) 312 Lincoln rents for $963 a month and sold for $156,000; and (3) 107 Adams rents for $1,155 a month and sold for $168,400. With this information, you calculate a range of GRMs for rental houses in this neighborhood:

GRM = Sales price/Monthly rent

Property	Sales Price		Monthly Rent		GRM
214 Jackson	$148,200	÷	$1,045	=	142
312 Lincoln	156,000	÷	963	=	162
107 Adams	168,400	÷	1,170	=	144

If the house you value could rent for $1,000 a month, calculate a value range using the GRMs indicated by these other neighborhood rental houses:

Subject House (Estimated Value Range)

GRM		Monthly Rent		Value
142	×	$1,000	=	$142,000
162	×	1,000	=	162,000
144	×	1,000	=	144,000

Thus, the value ranges between $142,000 and $162,000.

The GRM method does not directly adjust for sales incentives, financing concessions, different features, location, property condition, or property operating expenses. So this technique yields a rough appraisal. Nevertheless, real estate investors use it as a quick rule of thumb. As with the comp sales approach, the GRM works best when you find similar properties in the same neighborhood.

For apartment buildings, the gross rent multiplier is calculated from *annual* rent collections rather than monthly. For example:

Multi-Unit Income Properties

Property	Sales Price		Total Annual Rents		GRM
2112 Pope (fourplex)	$280,000	÷	$35,897	=	7.8
1806 Laurel (sixplex)	412,000	÷	56,438	=	7.3
1409 Abbot (sixplex)	367,000	÷	53,188	=	6.9

The GRMs shown in these examples *do not necessarily* correspond to the GRMs that apply in your city. Even within the same city, neighborhoods differ in their GRMs. In the San Diego area, GRMs for single-family homes in La Jolla can exceed 400; in nearby Claremont, you may find GRMs in the 250 to 300 range; and in National City, GRMs can drop below 200. Even within the same neighborhood, GRMs for single-family houses often exceed those of condominiums. In San Francisco, small multi-unit buildings can sell with annual GRMs of 14 or higher. In Detroit, MI, I have seen annual GRMs of less than 4.

As with all appraisal methods, search out relevant *local* data before you calculate gross rent multipliers. To estimate market value, know the local (micro) submarkets (type of property, neighborhood, features, and condition). No set answer rules.

INCOME CAPITALIZATION

To value apartment buildings, investors use the direct capitalization technique. Recall that the direct capitalization method applies the following value formula:

$$V = NOI/R$$

V represents the value estimate. NOI represents the net operating income of the property. R represents the overall rate of return on capital that buyers of similar income properties typically require. Here's an example.

Net Operating Income

Investors define net operating income as annual gross potential rental income from a property less vacancy and collection losses, operating expenses, replacement reserves, property taxes, and property and liability insurance. Study this net income statement for an eight-unit apartment building where each unit rents for $725 a month:

Income Statement (Annual)

1. Gross annual potential rents ($725 × 8 × 12)	$69,600
2. Income from parking and storage areas	6,750
3. Vacancy and collection losses at 7%	(5,345)
4. Effective gross income	$71,005
Less operating and fixed expenses	
5. Trash pickup	$1,440
6. Utilities	600
7. Registration fee	275
8. Advertising and promotion	1,200
9. Management fees at 6%	4,260
10. Maintenance and repairs	4,000
11. Yard care	650
12. Miscellaneous	3,000
13. Property taxes	4,270
14. Property and liability insurance	1,690
15. Reserves for replacement	2,500
Total operating and fixed expenses	$23,885
16. Net operating income (NOI)	$47,120

The following list explains each of the lines in the net income statement:

1. *Gross annual potential rents.* This amount is the largest possible sum of rents that you could practically bring in at current market rent levels and 100 percent occupancy.

2. *Income from parking and storage areas.* This property has a 16-car parking lot. A shortage of on-street and off-street parking in the neighborhood makes it profitable for the owner to rent the parking spaces independently of the apartment units. Also, the owner built storage bins in the basement of the building that are available for rental to tenants.

3. *Vacancy and collection losses.* Market vacancy rates in the area typically range between 5 and 10 percent. Currently, all units in this building are rented. But even the best-managed apartments experience some vacancies when apartments turn over. Add in some losses for tenants who disappear owing rents that exceed the amounts of their security deposits.

4. *Effective gross income.* This term refers to the actual amount of cash that an owner receives net of vacancy and collection, but before operating, fixed, and financing expenses.

5. *Trash pickup.* Self-explanatory.

6. *Utilities.* In this property, tenants pay their own unit utilities. The property owner pays for lighting in the hallways, basement, and parking area.

7. *Licenses and permit fees.* Apartment building owners must sometimes pay for business licenses and other fees. For this property, the owner pays a rental property registration fee.

8. *Advertising and promotion.* These units generally rent by word of mouth, Craigslist.org, or a *For Rent* sign that's posted on the property. However, to be safe, an advertising and promotion expense of $150 per year per unit is allocated to the operating budget.

9. *Management fees.* The owner of this apartment building self-manages the property. Nevertheless, he should pay himself the same amount he would otherwise have to pay a property management firm. Keep returns for labor distinct from returns on investment. Do not reward the seller for the work that you will contribute to the property.

10. *Maintenance and repairs.* The current owner and her husband clean, paint, and make small repairs around the property. These labors deserve payment from the property's rent collections.

11. *Yard care.* The owner pays this amount to one of the tenants to keep the grass cut, rake leaves, and shovel snow off the walks.

12. *Miscellaneous.* This expense covers legal fees, supplies, snow removal from the parking lot, municipal assessments, auto mileage to and from the property, and other items not accounted for elsewhere in the income statement.

13. *Property taxes.* This item includes city, county, and state taxes annually assessed against the property. BEWARE: Tax assessors periodically revalue properties to reflect increases in market prices. Future tax bills could jump 30 to 40 percent over the amount of the previous tax years. Similarly, if your purchase price comes in less than the assessor's current assessed value, you may see a reduced tax bill.

14. *Property and liability insurance.* This insurance reimburses for property damage caused by fire, hail, windstorms, sinkholes, hurricanes, and other perils. It also pays to defend against, and compensate for, lawsuits alleging owner negligence (e.g., slip-and-fall cases).

15. *Reserves for replacement.* Building components wear out. The roof, plumbing, appliances, and carpeting must be replaced periodically. As per the income statement, average out these nonroutine costs on a per-year basis.

16. *Net operating income (NOI).* After you itemize and total all operating expenses, subtract this sum from the effective gross income. The resulting figure equals net operating income (NOI).

When you calculate NOI, include all expenses for the coming year. Never accept a seller's income statement as accurate. Sellers notoriously omit and underestimate expenses. (Corporate CEOs aren't the only ones who try to dress up their numbers to paint a pretty picture.)

Ask to see the seller's tax return IRS Schedule E for the subject property. The truth will probably sit somewhere between the owner-prepared income statement for sales purposes (where income is likely to be overstated and expenses understated) and a tax return (where you might detect understated income and overstated expenses). Even if the seller truthfully reports *last* year's income and expenses, estimate how each of those figures might move up or down in the coming years. You buy the future, not the past.

Are property tax assessments headed up? Are vacancy rates (or rent concessions) increasing? Have utility companies scheduled any rate increases? Has the seller deferred maintenance on the property? Has the owner allocated enough maintenance expenses to cover replacement reserves? Has the seller self-managed or self-maintained the property and therefore failed to include items as cash expenses? When calculating NOI, never accept numbers on faith. Savvy investors realistically reconstruct seller-prepared NOIs.

Estimate Capitalization Rates (R)

After figuring NOI, next decide what capitalization rate (R) to use. When you buy an income property, you pay now for the rents the property will produce over the next 20, 30, or 40 years (or longer). The question becomes how much these future rents are worth in today's dollars (i.e., the property's market value). If the appropriate capitalization (cap) rate is 8.5 percent, then the market (capital) value of this eight-unit apartment building equals $554,365:

$$\$47{,}121\,(\text{NOI})/.085\,(\text{R}) = \$554{,}365\,(\text{V})$$

But where does that .085 percent "cap rate" come from? You estimate it from the cap rates that other investors have applied to buy similar properties. Say a real estate agent gives you NOI and sales price data on four similar apartment buildings that recently sold:

Market Data

Comparable Property	*Sales Price*	*NOI*	*R*
Hampton Apts. (8 units)	$533,469	$43,211	.081%
Woodruff Apts. (6 units)	427,381	35,900	.084
Adams Manor (12 units)	694,505	63,200	.091
Newport Apts. (9 units)	671,241	53,700	.080
Subject (8 units) (estimated)	544,365	47,121	.085

From these data, calculate a market-derived cap rate for each property (provided sale meets the criteria of a market value transaction). When investors in this area buy small income properties similar to the subject property, they figure cap rates between 8.1 and 9.1 percent. So it appears that the market of comp sales indicates a cap rate of around 8.5 percent for the subject property.

Compare Cap Rates

In your market, you may not discover sufficiently similar properties with such a narrow range of cap rates. You might find that some apartment buildings have sold with cap rates of 5 to 6 percent (or lower) and others have sold with cap rates of 8 to 9 percent (or higher). Why such differences?

You pay for a *quantity* of future rental income, and you pay for the *quality* of that income. Today's price also incorporates expectations about the future price/income gains for that property. The greater its *expected* rate of appreciation, the higher the price you pay now. Therefore the higher the quality of the income stream, and the larger the expected gain in price, the lower the capitalization rate (or the lower the quality of the property's income and price gain potential—in the eyes of the market—the higher its cap rate).

To illustrate: You compare two fourplexes. One is a relatively new property located in a well-kept neighborhood near a city's growth corridor. Several nearby office towers are under construction. The other fourplex is located in a deteriorating part of town. Major employers have moved out, closed, or laid off workers. Crime rates are high and moving higher. Two recent drug-related murders made front-page news.

If the annual NOIs for these two fourplexes are, respectively, \$24,960 and \$12,480, how much would investors pay for each property? If investors applied a 10 percent cap rate to each property's income stream, they would value the properties as follows:

$$\$24{,}960\,(\text{NOI})/.10\,(\text{R}) = \$249{,}600\,(\text{V})$$
$$\$12{,}480\,(\text{NOI})/.10\,(\text{R}) = \$124{,}800\,(\text{V})$$

But investors would not apply a like cap rate to these very unlike properties because the quality of their income streams differs. The better-located property offers more stable rents, less neighborhood risk, and greater expected gains in price. Investors might actually capitalize the respective NOIs of these two fourplexes at rates of, say, 6 percent and 15 percent.

$$\$24{,}960\,(\text{NOI})/.06\,(\text{R}) = \$416{,}000\,(\text{V})$$
$$\$12{,}480\,(\text{NOI})/.15\,(\text{R}) = \$83{,}200\,(\text{V})$$

Because most investors would rather own a property in a prospering area as opposed to a troubled area, they will pay significantly more *for each dollar of income* produced by such a property.

The Paradox of Risk and Appreciation Potential

Odd as it may seem, the higher-priced "low-risk, high-appreciation" properties may actually produce more risk and lower gains in price than their low-rent, highly troubled cousins who are located in the wrong part of town.

Compare Relative Prices and Values

Consider this stock market analogy. If you could buy a quality, high-growth company's stock at a P/E of 10 or a low-growth company's stock at a P/E of 10, by all means invest in the high-growth company. If you could buy a low-risk, high-appreciation-potential property with a cap rate of 10 percent or a higher-risk, lower-appreciation property with a cap rate of 10 percent, buy the low-risk, high-appreciation property. However, that's not how markets typically price either real or financial assets.[2] In the real world, investors bid up prices for high-quality, growth-area properties and reduce their bids for so-called high-risk properties in less desirable neighborhoods. To figure out which type of property and location offers the most profit potential, compare their relative prices and cash flows.

When investors optimistically bid up the prices of some properties, neighborhoods, and cities relative to other properties, neighborhoods, and cities, you can sometimes profitably redirect your investment strategy. In other words, don't calculate market cap rates for just one type of property or neighborhood. Learn as much as you can about a variety of submarkets and areas of the country. For instance, do you believe that San Francisco apartments can continue to command a four- to eight-fold price premium over those of Charlotte, North Carolina?

You overpay for a property when: (1) you apply a cap rate that's too low for the property and neighborhood you're buying into, or (2) you fail to realize that market cap rates themselves may sit too low relative to other types of properties or locations. On the other hand, you can earn extraordinary profits when you discover lesser-publicized (high cap rate) properties (locations) that yield high rents relative to the price you have to pay. (We further explore this opportunity in Chapter 15.)

VALUATION METHODS: SUMMING UP

"Market value" does not necessarily equal "appraised value" or "sales price." Market value refers to the sale price of a property when a sale meets the criteria of a market value transaction. To estimate the market value of a subject property as it compares with other similar properties that have sold, first investigate the terms and conditions under which

[2] If you bought Microsoft and JC Penney stock in 1998 and sold in 2004, JC Penney stock would have paid you higher returns. As a high-profile growth company, in 1998, Microsoft's stock price already included a hefty premium for its expected growth.

the comparative properties sold. A property down the street that sold for $200,000 after just three days on the market does not necessarily indicate that a similar property nearby will sell for $200,000. It depends on the terms of sale and the detailed features of each property.

Even though you can use three approaches to value a property, those three approaches do not result in the same value estimates. You work with imperfect data. You need to decide which approach(es) best serves your purposes. The accuracy of your market value estimate directly relates to how well you identify and evaluate a property's features. Observe the differences (positive or negative) that make a difference. Investment decisions require you to know features, properties, neighborhoods, construction costs, and lot values. Technique never substitutes for knowledge, close reasoning, and wise judgment.

Past price increases (decreases) do not forecast the future. It's tougher to make money when you buy a property that's about to fall in value—even if you buy it at a "bargain price." And you can make great returns—even when you pay market value (or above)—if you have identified a property (or location) that's about to gain increased popularity.

Appraisal Limiting Conditions

One final note on appraisal reports: Property appraisers hedge their estimates of value with many limiting conditions. Especially relevant (Figure 3.1) are limitations 1, 2, 6, and 7:

- ♦ Appraisers do not investigate title. They assume that a property's bundle of fee simple rights is good and marketable. For a legal guarantee of property rights, consult a title insurance company.
- ♦ Appraisers do not survey the boundaries of a site, nor do they necessarily note encroachments or other potential site problems. To precisely identify site dimensions, encroachments, and some easements, employ a surveyor and walk the property lines.
- ♦ Appraisers assess the condition of a property that they see through casual inspection. To thoroughly assess the soundness of a property and its systems (heating, cooling, electrical, plumbing), hire a professionally competent building inspection service or skilled tradesperson.
- ♦ Appraisers gather much of their market information from secondhand sources (real estate agents, government records, mortgage lenders, and others). Appraisers seldom go inside the comp properties that they include in their appraisal reports. Because they incorporate nonverified secondhand data, appraisals often

err in fact and interpretation. Accept an appraisal report as "for-what-it's-worth" information. Never give it more weight than it deserves. (At a minimum, I verify the appraiser's comp property data before I decide how much respect I should give to an appraiser's estimate of value.)

Valuation versus Investment Analysis

Before you buy, accurately understand the property's market value. Yet market value itself does not tell all you need to know to make profitable investment decisions. Besides figuring out what a property is worth today, answer these questions:

- ♦ Will the property generate adequate cash flows?
- ♦ Can you expect the property to increase in price?
- ♦ Can you add value to the property?

To address these investment issues, we turn to the following chapters.

4

MAXIMIZE CASH FLOWS AND GROW YOUR EQUITY

To value income properties, investors capitalize net operating income (NOI) by dividing it by the capitalization rate (R). But because you will finance your investment properties, you won't pocket the full amount of NOI that your property produces. Nor does the capitalization rate itself reveal your actual yearly cash return on your actual amount of invested cash (i.e., your down payment). So, now you will learn how to calculate the returns you can achieve through leverage.

WILL THE PROPERTY YIELD GOOD CASH FLOWS?

From Chapter 2 recall that you calculate before-tax cash flow (BTCF) as follows:

NOI less debt service (annual mortgage payments) equals BTCF

Now let's return to the eight-unit apartment building example from Chapter 3. We calculated NOI for that property at $47,121. Applying an 8.5 percent cap rate, we figured the property's market value as $544,365:

$$\$544{,}365\,(V) = \$47{,}121\,(NOI)/.085\,(R)$$

If you finance this property with a mortgage loan-to-value (LTV) ratio of 80 percent (20 percent down) at 7.5 percent interest, amortized over a term of 25 years, figure your mortgage balance and annual payments as follows:

$544,365 (value)
.80 LTV
$435,492 loan amount

With mortgage terms of, say, 7.5 percent, fully amortized over 25 years, the monthly mortgage factor equals $7.39 per $1,000 borrowed. Because you originally borrowed $435,492, your monthly payments equal $3,218 for a yearly total amount of $38,618:

$435,492 ÷ 1,000 = 435.492
435.492 × $7.39 (mo. pymt. per 1,000 borrowed) = $3,218
12 × $3,218 = $38,618 (yearly amount paid)

Given the above amount of mortgage payments (debt service), this eight-unit apartment building brings in a first-year BTCF of $8,503:

$47,121 (NOI)
less $38,618 (yearly debt service)
$8,503 (BTCF)

To calculate your annual cash-on-cash return on investment (i.e., your annual rate of return on the actual amount of out-of-pocket cash that you have invested), divide the down payment (original cash investment) into your annual before-tax cash flow (BTCF):

Cash ROI = $8,503 (BTCF)/$108,873 (down payment) = 7.81%

Does this first-year cash-on-cash rate of return look attractive? That would depend on the property's potential. Can you add value to the property through creative improvements? Is the property strategically positioned for appreciation? If you see strong potential for the property, you might accept a relatively low return from cash flows. But maybe you're not happy with an annual BTCF of $8,503 and a cash-on-cash ROI of 7.81 percent. Does this mean you should cross this property off your list? Not necessarily. Before you reject a property that fails to produce satisfactory cash flows, look for ways to increase those returns:

- Could you arrange alternative financing with lower annual payments?

- Should you decrease (increase) your down payment?
- Can you buy at a bargain price?

Arrange Alternative Terms of Financing

As explained in Chapter 2, smart investors think through their financing alternatives. You can restructure the cost and/or terms of financing to improve cash flows. In a first pass through the numbers for this eight-unit apartment building, we assumed a 7.5 percent interest rate amortized over 25 years with a 20 percent down payment. To improve the cash flows, try the following:

- Seek a lower interest rate.
- Lengthen the term of the mortgage.
- Use some type of balloon second mortgage.
- Combine several of these alternatives.

To obtain a lower interest rate, switch to an adjustable-rate mortgage, ask for below-market seller financing, buy down the interest rate, or perhaps assume a seller's lower-interest-rate mortgage. Here's how an interest rate of, say, 6.7 percent would boost cash flows:

Monthly payment per $1,000 at 6.7% for 25 years = $6.88
435.492 × $6.88 = $2,996 monthly payment
12 × $2,996 = $35,954 annual payments (debt service)
$47,121 (NOI)
less $35,954 (yearly debt service)
$11,167 (BTCF)
ROI = $11,167 (BTCF)/$108,873 (down payment) = 10.26%

If this BTCF and ROI still fall short of your investment goal, extend the amortization period from 25 to 40 years (with, say, a balloon at year 10 or 15, if necessary).

Monthly payment per $1,000 at 6.7% for 40 years = $6
435 × $6 = $2,610 per month
12 × $2,610 = $31,320
$47,121 (NOI)
less $31,320 (debt service)
$15,801 (BTCF)
ROI = $15,801 (BTCF)/$94,242 (down payment) = 16.77%

Now return to the first calculation, when you borrowed mortgage money from a bank at 7.5 percent interest with a 25-year term. Say the sellers won't carry back the entire amount of the financing but will give you a $100,000 balloon second mortgage due in five years, with interest only payable at 6 percent. You borrow $335,492 from the bank on its terms, and $100,000 from the sellers on their terms. Here's what your cash flow would look like under this financing arrangement.

335.492 × $7.39 × 12 = $29,775 (to the bank)
.06 × $100,000 = $6,000 (to the seller)
Total annual debt service = $35,775 ($29,775 + $6,000)
$47,121 (NOI)
less $35,776 (debt service)
$11,345 (BTCF)
ROI = $11,345 (BTCF)/$108,873 (down payment) = 10.42%

Although the cash flow here falls below the seller-financed transaction, it still beats the baseline bank financing. My intent here is not to show which type of financing seems best. Rather, it is to encourage you to calculate possible returns via alternative financing scenarios, and then discover which (if any) financing might make a deal work—for you and the sellers. In just the few possibilities shown here, the first-year BTCF ranged from a low of $8,502 to a high of $15,765. Change the terms of financing and you might materially improve (or diminish) the financial performance of a property.

Decrease (or Increase) Your Down Payment

You also change cash flow and correspondingly, cash-on-cash return, when you decrease (or increase) your down payment. Instead of placing 20 percent down ($108,873) on this eight-unit property, you close the deal with a 10 percent down payment of $54,436.50. The seller finances the balance of $489,928 at 7.5 percent interest for 25 years (with perhaps a shorter term balloon payoff):

489.9285 × $7.39 × 12 = $43,446 (debt service)
$47,121 (NOI)
less $43,446 (debt service)
$ 3,675 (BTCF)
ROI = $3,675 (BTCF)/$54,436 (down payment) = 6.75%

In this case, a lower down payment gives you a thin margin of cash flow and drops your cash-on-cash ROI to 6.75 percent. By comparison, here's what happens to cash flow and ROI if you buy with 10 percent down, seller financing at 6.5 percent interest, amortized over 40 years:

$459.928 \times \$5.85 \times 12 = \$32{,}287$ (debt service)
$47,121 (NOI)
less $32,287 (debt service)
$14,834 (BTCF)
ROI = $14,834 (BTCF)/$54,436.50 (down payment) = 27.25%

This outcome looks attractive. Combine the benefits of the lower interest rate with the leveraged gain from higher LTV and you beat the returns realized with the baseline bank financing (20 percent down, 7.5 percent, 25 years).

In areas of the country with generally high property prices, you may find that well-kept properties (single-family houses, duplexes, fourplexes, small apartment buildings), when financed with high LTV loans, produce negative cash flows. Say that our eight-unit building is located in a prime neighborhood that's in high demand by both owner-occupants and investors. Instead of a cap of 8.5 percent, the market values properties in this neighborhood with a 7.0 percent cap rate. Given this lower cap rate, this building commands a higher value ($673,157 versus $544,365):

$$\$673{,}157\,(V) = \$47{,}121\,(NOI)/.07\,(R)$$

If you finance with an 80 percent loan, you'll put down $134,631 and secure a mortgage of $538,526. With a 7.5 percent interest rate and a 25-year term, your annual mortgage payment would total $47,756:

$538.526 \times \$7.39 \times 12 = \$47{,}756$ (debt service)
$47,121 (NOI)
less $47,756 (debt service)
$ –635 (BTCF)

In situations of negative cash flow (an alligator), search for low-cost financing. If that doesn't work, cover the negative (feed the alligator) from other income or increase the amount of your down payment. With 30 percent down ($201,947.1) on a price of $673,157, you would borrow $471,210 and then pay back $43,242 a year:

$471.210 \times \$7.39 \times 12 = \$41{,}786$ (debt service)
$47,121 (NOI)
less $41,786 (debt service)
$ 5,335 (BTCF)
ROI = $5,335 (BTCF)/$201,947.10 (down payment) = 2.645%

At least the larger (30 percent) down payment converts your negative cash flow into a positive, but your cash on cash looks anemic. Buy such a property if you can profitably improve it, or when neighborhood property values are about to escalate. Alternatively, to combat low cap rates or negative cash flows, ferret out bargain-priced properties or move your search for properties to lower-priced (higher cap rate) geographic areas.

Buy at a Bargain Price

To increase your cash flow (or avoid a negative cash flow), locate properties that you can buy at less than market value. Although this technique requires hustle, knowledge, and creativity, you can do it. Motivated sellers, lender-owned properties (REOs, i.e., bank-owned real estate), foreclosures, tax sales, uninformed sellers, trade-in properties, and other sources of bargains routinely account for between 10 and 20 percent of property sales. More recently, such distress sales—in some cities—have exceeded 50 percent of total sales.

Sources of bargains are discussed in later chapters, but at least here you can see how a below-market price can lead to higher cash flows.

Return to the eight-unit example that was valued with an 8.5 percent cap rate at $544,365. With the hypothetical baseline bank financing of 20 percent down and 7.5 percent, 25-year terms, the property produced a first-year cash flow of $8,502. But what if you could buy that property (or a similar one) at a bargain price (say 10 percent under market)? You would pay $489,928.50, put $97,935.70 down, and borrow $391,942.80 (80 percent). Your annual debt service would fall to $34,757, and your cash flow (BTCF) would increase to $11,539:

391.943 × $7.39 × 12 = 34,757 (debt service)
$47,121 (NOI)
less $34,757 (debt service)
$12,364 (BTCF)

Your first-year ROI would increase to 12.62 percent:

$$\text{ROI} = \$12{,}364\,(\text{BTCF})/\$97{,}985.70\,(\text{down payment}) = 12.62$$

In markets where properties typically fail to give you the cash flows you want, don't give up your search. Instead, discover a property you can buy at a bargain price. In today's markets, distressed sellers have multiplied. Careless property management, dumb financing, and a down economic cycle have conspired to force the sale of hundreds of thousands of properties at bargain prices.

Should You Ever Pay More than Market Value for a Property?

Recall the negotiating ploy where you tell sellers that you will pay their price if the owner will sell on your terms. You stroke the sellers' egos and give them a price they can brag about. But (ostensibly) you'll earn good cash flows and a high ROI because you receive a high LTV and low-cost financing.

Staying with the eight-unit example, say the sellers accept your offer and set a price of $600,000 ($544,365 market value). You say, "Fine, here are my terms: $25,000 down, 5.75 percent interest, and 40-year payoff period with a balloon note due in 12 years." This arrangement means that the sellers would carry back a mortgage (or contract for deed) in the amount of $575,000. Here's how the numbers work out:

575.000 × $5.33 × 12 = $36,777
$47,121 (NOI)
less $36,777 (debt service)
$10,344 (BTCF)
ROI = $10,344 (BTCF)/$25,000 (down payment) = 41.38%

Wow! These numbers look terrific. Compared with a market value price and bank financing, you've achieved three important objectives: (1) You reduced the cash you need to buy the property; (2) you increased your cash flow; and (3) you lifted your ROI into superstar territory. You can readily see why some authors encourage you to trade off a higher price for a low down payment, low-cost OWC financing.

Nevertheless, you created a serious problem. You owe more than the property is worth. Absent a strong increase in market price, you could not sell the property for an amount high enough to pay off the outstanding mortgage balance (a dilemma faced by millions of buyers in the country's recent downturn). Just as troubling, if market interest rates drop, you could not refinance your outstanding mortgage balance. Your one-time favorable financing now locks you into a higher than market rate for what could turn out to be an extended period (especially in a less-than-robust market).

To protect against these risks, negotiate these two financing clauses:

1. *The right to assume.* If a buyer can take over your 5.75 percent financing, you increase your ability to sell the property without coming up with cash out of your own pocket.
2. *The right to prepay the loan balance at a discount.* To help you overcome the owe-more-than-you-own mortgage problem, insert a prepayment discount clause into your financing agreement. If you pay off the seller within the first five years (for example), the seller will discount the payoff balance by, say, 5 or 10 percent. Sellers who are eager to cash out their loan on a property may agree to this discount. (Even when an OWC mortgage does not include a prepayment discount clause, sellers may later accept such an offer. But if you offer a discount, play it coy. First raise the possibility of early payoff to prompt a reaction from the seller. Generally, the more eager the seller, the greater the discount you negotiate.)

"You set the price, I'll set the terms," can work to decrease your down payment, increase your annual cash flow, and leverage up your ROI. Yet if such prices and terms leave you with negative equity, you've crossed into risky territory. Calculate whether the benefits of the deal outweigh these risks. Most importantly, never assume that market appreciation rates of 6 or 8 percent a year will bail you out of the excessive mortgage problem. Maybe you will get lucky, but don't bet the ranch on it.

The Debt Coverage Ratio

You've seen how financing (mortgage amount, interest rate, amortization period) can increase or decrease your annual cash flows and ROI. In addition, recall that the lender may apply a debt coverage ratio (DCR) as one of its underwriting criteria. The lender wants to see whether the property's NOI is large enough to amortize the loan and provide a margin of safety. For example:

$$\text{DCR} = \$47{,}121\,(\text{NOI})/\$38{,}618\,(\text{debt service}) = 1.22$$

Among lenders who incorporate debt coverage ratios into their underwriting decisions, for moderate to high-quality apartment buildings, a DCR range of 1.1 to 1.3 usually proves acceptable. If a property's NOI fails to provide enough cushion for the lender, rework the terms of the financing. Investors frequently work their deals not only to meet their own cash flow requirements but also to meet a lender's required DCR.

Numbers Change, Principles Remain

Previous discussions focused on the cash flows of an eight-unit apartment building with a variety of interest rates, loan balances, amortization periods, cap rates, and purchase prices. The numbers used in these examples illustrate techniques and principles—not the specific numbers you should apply in your market or for your investment goals.

In Tulsa, not long ago, you could buy a good eight-unit rental property for less than $300,000. In San Francisco, you can pay $2 million for a similar building. In Tulsa I've seen cap rates over 10 percent. In San Francisco, I've seen them at less than 4 percent. Property markets differ. Even within the same city, properties, neighborhood quality, gross rent multipliers, and terms of financing vary.

When you buy condos, single-family houses, or small apartment buildings, search throughout your local area. Talk with well-informed realty agents, mortgage loan officers, real estate appraisers, property managers, and real estate investors.

As you learn the numbers that apply to proposed deals, work through your value estimates and ROI figures as illustrated in this chapter (and Chapter 3). To a certain degree, investing profitably means *structuring* deals to yield positive cash flows and high ROIs while avoiding foolish financial risk. When you buy at a below-market price, you increase your odds of success. But "price" represents one variable. Without positive cash flows and sufficient cash-on-cash returns, even a "bargain-priced" deal can turn sour.

WILL THE PROPERTY YIELD PROFITABLE INCREASES IN PRICE?

In addition to yearly cash flows, property investors expect their properties to sell at prices substantially greater than they paid. Over longer periods, even price increases of 3 or 4 percent per year can add hundreds of thousands of dollars to your net wealth.

Buy just one rental unit at a price of $100,000 and finance it with a $90,000 mortgage at 6.5 percent interest and a 30-year term at an annual appreciation rate of 4 percent. After 15 years, that $100,000 unit would be worth $180,000. Subtract your outstanding mortgage balance of $64,803, and your $10,000 down payment has grown 11-fold to $115,197. After 30 years, your mortgage balance would drop to zero, and the value of the property (at a long-term 4 percent yearly average rate of appreciation) would total $324,340. In a down cycle, price increases may express hope more than reality. But over a period of 15 to 30 years, an average price gain of 4 percent per year matches past experiences. In fact, experience shows that investors who acquire bargain-priced properties during down cycles typically gain long-run price increases that average greater than 4 percent a year.

Buy just three or four $100,000 rental units within the next several years, and at retirement (if you're under age 50), your net wealth from those units will total somewhere between $400,000 and $1 million. With only modest increases in rents, your income from those properties could reach $6,000 to $10,000 a month. And that's from only three or four units! After 18 years, today's monthly rent of $1,000 would grow to $2,000 a month—assuming a 4 percent average increase each year.

[To Californians and residents of other high-priced areas, these purchase figures look quite low, so double or triple them. The same principle applies. To improve your cash flows, look for properties in lower-cost geographic areas. Also, join with others and buy multi-unit buildings. Commercial properties provide another option (see Chapter 15). "Fixers," too, offer a good alternative. (See especially Chapter 8 herein and my book *Make Money with Flippers, Fixer-Uppers, and Renovations,* John Wiley & Sons, 2008, 2nd ed.)]

Low-Involvement versus High-Involvement Investing

Hold properties for income and appreciation for a period of 15 to 30 years (or more) and you've put in place a low-involvement investment strategy. Anyone who is serious about building wealth can come up with the limited time and money necessary to make this modest strategy pay off. However, if you want to build wealth over a shorter period, then pursue high-involvement strategies to boost value. High involvement won't necessarily require more cash, but it will require more time, effort, and knowledge.

To beat the market average price increases, spot communities, neighborhoods, and properties that are positioned for increased popularity and faster appreciation.

Most everyone now realizes that short-term price increases are never guaranteed. Job layoffs, speculative overbuilding, high interest rates, tight credit, and other factors can temporarily push property prices into a tailspin. Yet especially in perilous times (when fear and confusion drives others to the sidelines), opportunities to score large price increases multiply. Look for areas that signal strong potential. Here's how to find these star performers.

Compare Relative Prices of Neighborhoods (Cities)

An oft-cited cliché in real estate tells investors to "buy in the best neighborhoods you can afford; the best neighborhoods always appreciate the fastest." On closer inspection, this advice makes no sense. No neighborhood or community can persistently outperform all others. The law of compound interest proves the statement false. (Similarly, recall that the stock price of Microsoft—a great company—was higher in 1999 than it was in the fall of 2008.)

Say that you can choose between a neighborhood where apartment buildings are priced at $100,000 per unit (College Park) and a neighborhood where apartment buildings are priced at $50,000 per unit (Modest Manor). Within the recent past, properties in College Park jumped in value by 8 percent a year. Units in Modest Manor have moved up by only 3 percent a year. Can College Park outpace Modest Manor forever? Not likely. A look at projected values shows why.

Future Appreciated Values: College Park versus Modest Manor

Years	$100,000 Units at 8% p.a.	$50,000 Units at 3% p.a.
3	$125,970	$54,635
6	158,690	59,700
9	199,900	65,200
12	251,820	71,250
15	317,222	77,900
20	466,100	90,300

Today, rental units in College Park cost *twice as much* as those located in Modest Manor. But after 20 years of (assumed) faster appreciation, these superior higher-priced units would cost *more than five times as much* as their "inferiors." Unless some rare market forces were at work, such an unbalanced situation would not occur.

Long before such exaggerated price differences could result, increasing numbers of potential investors (and tenants) would become priced out of College Park. In response, they would switch their buying (or renting) to Modest Manor. Price gains in College Park would slow. Price gains in Modest Manor would accelerate.

The intelligent investor never assumes that future rates of appreciation will mirror the recent past. (Nor do they assume recent price declines can be trend-lined into the future.) Intelligent investors compare the prices and features of a variety of properties, neighborhoods, and cities. They compare local economies. They note changes up or down in the number of for sale and for rent properties. Then they search for properties and locations that show the best possibilities for price gains.

Undervalued Neighborhoods and Cities

At any time and in any area, no fixed relationship applies to neighborhood or community appreciation potential. Sometimes lower-priced areas represent a great buy. At other times, higher-priced areas look best. Sometimes new developments beat established neighborhoods; sometimes established beats new. Nor can anyone advise definitively about close-in versus far-out, well-kept versus run-down, or low-crime versus high-crime. Neither racial nor ethnic composition, nor household income level, nor occupational status necessarily relates to the potential price gains of a neighborhood.

The neighborhood or city that offers the best outlook for price gains is the neighborhood (city) where growth prospects, property prices, and rent levels look good relative to the growth prospects, prices, and benefits offered by other areas. Consider one of my favorite examples of how modest can appreciate faster than classy.

Beverly Hills versus Watts (South Central Los Angeles)

Between 1985 and 1989, property prices in prestigious Beverly Hills had shot up by 50 percent or more. During the same period, property prices in the troubled neighborhood of Watts had barely budged. But by 1995, $5 million (1989) properties in Beverly Hills were selling at reduced prices of $3 million to $4 million, whereas $85,000 (1989) properties in Watts were selling at the increased price of $125,000. Between 1989 and 1995, property investors who owned units in troubled South Central Los Angeles outperformed investors who owned properties in the movie star haven of Beverly Hills.

In response to this fact, here's what I wrote in 1995 in the second edition of this book: "Will appreciation rates in South Central continue to outpace Beverly Hills? I don't think so. Relative to other premier neighborhoods in world-class cities, homes in Beverly Hills now stand as terrific bargains. With the California economy at last climbing out of recession, house prices and rentals in Beverly Hills may now be positioned to hit new record highs."

Looking back now, you can see that my forecast proved correct. Between 1995 and 2005, upscale property prices in California did hit record highs. Although South Central prices also continued to climb, you would have made far more money had you invested in Beverly Hills. Between 2008 and 2009 in Dubai, the multimillion-dollar villas located on world-famous Palm Jumeira suffered price declines of nearly 50 percent off their peak. During this same period the modest town homes of Dubai's International City held their value. Dubai was running a huge excess of top-end villas and apartments, whereas affordable units such as those of International City remained in short supply relative to the demographics of the population.

As these examples show, investors can profit (or avoid loss) when they study neighborhood home prices relative to features, benefits, and buyer/renter demographics. Savvy buyers never prejudge. They gather facts about supply and demand. They reason. They forecast the future. They neither extrapolate the past into the future nor do they apply clichés and slogans to anticipate price movements.

Apart from relative prices, what facts should you compare?

- Demographics
- Accessibility
- Job centers
- Taxes, services, and fiscal solvency
- Construction and renovation
- Land-use laws
- Civic pride
- Sales and rental trends

Demographics

Demographics refer to the income levels, occupations, education, ages, household size, household composition, and other population characteristics. You can obtain such data from the U.S. Bureau of Census and commercial market research firms (see www.census.gov). The magazine *American Demographics* alerts its readers to emerging demographic trends. Truly news you can use.

More important than *current* neighborhood demographics, learn who is moving *into* the area. A historically lower-income area that's attracting middle- or even upper-middle-income younger residents points towards appreciation potential. Likewise, an area where many residents are moving from welfare to jobs signals turnaround.

To learn about the people in an area, get out of your car. Talk with residents who are working in their yards or walking their dogs. Talk with Realtors, mortgage loan officers, retail shop owners, schoolteachers, postmen, taxi drivers, policemen, government planners, and others whose firsthand, everyday experience places them in the know about an area. Ask anyone and everyone how the area is changing and whether they see these changes as positive or negative. Ask the people you talk to what they like least and what they like most about the neighborhood. Evaluate what you hear, see, and research. Then form your own conclusions. Do you think the people moving into the neighborhood are likely to push up home prices and rental rates? Or does "filtering down" point to deterioration?

Accessibility (Convenience)

Areas don't change their position on the face of the earth. Nevertheless, they can become more or less convenient relative to other areas and relative to their own past. Several years back, I chose to buy property in the southeast part of town rather than the more popular northwest corridor. Why? Lower prices, similar quality, and easier accessibility. Because of rapid growth and development, the freeway leading to the northwest corridor had become congested. What had been a 15- to 20-minute drive to town from those neighborhoods was now taking 45 to 60 minutes. And traffic was getting worse.

As a result, increasing numbers of renters and homebuyers decided that they did not want the hassle of fighting traffic every day. They switched their preferences to the east and southeast developments. Within three years, my properties jumped in value by 40 percent. Momentum feeds upon itself for a while.

Improved (Increased) Transportation Routes

Find out whether an area might become more convenient because of changing (or lower cost) transportation routes. Are any new or expanded freeways or toll roads planned or under construction? What about bridges, ferries, subways, commuter trains, or bus service? Will travel to and from a neighborhood or community become easier, cheaper, or faster? After the Euro tunnel connected England to France, British demand for vacation homes doubled the (historical) appreciation rate of attractive French properties. Discount airline fares increased the demand for Florida properties—especially among New Yorkers and Chicagoans.

Can you recall 15 or 20 years ago when some of those "outlying" developments were built in your area? Are they still outlying? More than likely they're now just minutes from shopping centers, office complexes, and restaurants. Because growth moves outward, identify how convenience will change. Developments, cities, or even countries that today seem far away may tomorrow sit just minutes from everything.

Jobs

Most people prefer to live close to their jobs. As you search for appreciation potential, discover neighborhoods that are situated near employers or employment centers that are adding jobs to their payrolls. Look for new or expanding office districts, factories, shopping centers, and distribution facilities. As these job sites fill up with employees, they will push up the prices and rents of nearby housing. When Sarasota Regional Medical Center underwent a major expansion, home prices in nearby neighborhoods jumped 40 percent within just a few years.

Taxes, Services, and Fiscal Solvency

As you ferret out neighborhoods, communities, and even countries in which to invest, check their property taxes, government services, political stability, and fiscal fitness. Does the area offer a high level of services and social programs? Are the public finances of the area well managed? Does the tax/benefit ratio for the community compare favorably with other areas? Consider all taxes and services. Do community governments provide residents relatively good value?

Co-ops, condos, and housing developments governed by homeowners' associations present another layer of inquiry. A homeowners' association functions as a government within a government. It issues rules and regulations, it provides services and recreational amenities, and it charges legally enforceable fees and assessments.

If you plan to buy into property development that is governed by a property owners' association, check out the association's "laws," services, fees, financial reserves, and fiscal solvency in the same way that you would check out a local government. Some property owners' associations have failed to put aside enough money to fund repairs and improvements. Owners will suffer costly assessments. (See my book, *Make Money with Condominiums and Townhouses,* John Wiley & Sons, 2003).

New Construction, Renovation, and Remodeling

Are neighborhood owners (especially those who have recently bought into the area) upgrading their properties? Are they painting exteriors, remodeling interiors, building additions, or installing amenities such as central heat and air, decks, patios, hot tubs, or skylights? Do you see properties brought back to life after years of neglect? Do you see front yard dumpsters loaded with remodeling debris? Check with contractors, home improvement stores, and government building inspectors. Note trends in building permits for the area. Learn whether spending for property improvements is increasing.

Look for new construction of housing, office buildings, manufacturing plants, retail stores, or parks and recreational facilities. New construction not only creates jobs, but if properly integrated into an area, it increases the area's desirability. Note, too, the prices or rental rates of any housing that's newly built or under construction. Is the new housing more expensive than the existing homes and apartments? If so, these higher prices indicate that a neighborhood is moving upscale.

Watch carefully, though. Too much new housing can temporarily pull prices and rental rates down. Although everyone thinks Oil Belt property values fell in the 1980s because of the collapse in oil prices, that's only a small part of the story. In fact, *overbuilding* (especially apartments and condominiums) proved far more damaging. In Houston, during the early- to mid-1980s, developers brought more than 100,000 new multifamily units to market. Apartment vacancy rates ran close to 20 percent. Rent levels for new luxury two-bedroom apartments fell to less than $300 a month. Low rents for apartments pulled down the prices of condominiums and houses.

In response to such an excess of competition, lenders tightened financing for new subdivisions, condominiums, and apartments. During the 1990s, fewer new rental units were built than in any other 10-year period since the 1960s. The stage was set for the 2000–2006 property boom.

After 2002, construction took off into the stratosphere. Builders set new records for construction of housing units—especially in such hot spots as Miami, Phoenix, and Las Vegas. Even worse, much of this excess was sold to speculators and shaky credit buyers. Just as we have experienced multiple times in the past, a downturn was sure to follow such excesses. (And as in the past, recovery and growth will again send property prices up to new peaks within a decade or so.) Before you invest, check whether new housing in competing areas is renting (selling) without difficulty and that vacancy rates aren't flying up toward 10 percent or higher. (Your local planning and building permits agency keeps detailed records of past, present, and planned construction.) Smart investors position themselves to profit from a down cycle. When foreclosures and REOs pile up and new housing starts collapse, they grab the bargains.

Land-Use Laws

Land-use laws include zoning, building codes, health and safety rules, occupancy codes, rent controls, environmental protection, historical preservation, architectural review boards, and many other laws, rules, and regulations. These laws may restrict growth and increase costs of development.

To forecast price gains for an area, learn community attitudes toward growth. Do current (or pending) land-use laws limit construction and drive up building costs? Is government restricting new supply? Is the amount of buildable land in short supply over the mid- to long run? While debates rage between pro-growth and no-growth forces, experience shows that in desirable areas where no- or slow-growth attitudes prevail, over time, rent levels and housing prices are pushed up. Compare the rate of increase in housing starts to the rate of growth in new households. A shortage of zoned, buildable land positions an area for above-average price gains—as long as the jobs, incomes, and desirability of the area increases.

Pride of Place

You're not buying the past, you're investing in the future. You and other property owners in an area can join together to improve the future of an area. Civic pride, community spirit, and community action can upgrade a neighborhood with a poor reputation into one that becomes "the place to be." Contrary to received opinion, you can change and improve the location of a property.

To evaluate price gain *potential,* assess the pride of place for neighborhood residents. Are they working individually and collectively to make their community a better place to call home? Are they cooperating with the people responsible for government services such as schools, libraries, police, street maintenance, parks and recreation, and public health? Are residents and public officials solving problems such as crime, graffiti, school quality, traffic congestion, or littered public areas?

Locate a neighborhood with genuine possibilities for improvement, and you locate a neighborhood with strong potential for price gains. When you, other property owners, and tenants work together, civic pride and community action can transform an ugly duckling to a peacock. (For dozens of examples, see *Fixing Broken Windows,* by George Kelling and Catherine Coles [Free Press, 1996].)

Sales and Rental Trends

Among the leading indicators of rising (or falling) property prices are sales trends and rental trends. As you move forward to a profitable career in real estate investing, create a system for tracking and recording trend data such as the number of "for sale" listings, new housing starts, sales prices, time on market, rent levels, and vacancy rates. Watch these trends.

You can detect market changes as they occur and sometimes score large short-term gains.

Sales Trends. As prices begin to increase in a neighborhood, time-on-market data will show increasingly faster sales. In slow markets, properties can sit unsold for months (180, 270, or 360 days, or longer). More positively, as average time on market falls from, say, 270 days to 180 days to 120 days, prices are about to go up. A decreasing inventory of "for sale" properties also points the way to rapid advances in property prices.

When the numbers of For Sale and For Rent signs dwindle, sellers soon raise their prices and rental rates. At the ebb of San Diego's major recession of the early 1990s, the local MLS included 18,000 homes for sale. By 2004, that number had fallen to 6,000. No wonder prices increased as "for sale" properties declined in number while jobs, population, households, income, and wealth continued to grow.

Rental Market Trends. Four major rental market trends include: (1) vacancy rates, (2) time on market, (3) annual rent increases (or rental concessions), and (4) rates of owner occupancy. Review the past 12 to 24 months. Are area vacancy rates falling or increasing? How long do vacant apartments or rental houses sit empty before they're rented? Visit a sampling of vacant units. Then follow up to learn their lease-up periods. What types of units rent the quickest? How do vacancy rates differ among various neighborhoods and communities? Do some types of buildings or units enjoy waiting lists? What are their features and locations?

Are rents steady or increasing? Or are property owners giving concessions like one or two months' free rent for a 12-month lease? Are homes in the area primarily owner occupied or tenant occupied? In which direction is the area trending? Look for areas where tenants are being squeezed out by homebuyers. Increasing numbers of homeowners usually signal higher property prices and higher rental rates for the relatively few rental units that remain.

Of course, every general principle gives rise to exceptions. For example, during the latest boom, houses in family-dominated neighborhoods close to the University of Florida jumped 50 to 100 percent in value within less than 5 years—even though renters were increasingly displacing homeowners.

Why? Investors had discovered that they could lease these houses out to groups of students and collect rents of $1,500 to $2,500 per month. Accordingly, they bid up prices. Out-of-town parents of students also entered the market. They would buy a house for a son or daughter—who would then bring in several other students as roommates and charge each one $400 to $600 per bedroom.

The lesson: Learn trends early. Track the data. Talk with those who live and work in the area. Act on inside information.

SUMMING UP

To discover properties that will gain from higher-than-average appreciation, thoroughly track market data. Monitor changes in selling prices, accessibility, pride of place, and community action. Property prices and rent levels gallop ahead or fall behind because buyers and tenants persistently shop neighborhoods and communities to discover the best *values*—not necessarily the best features or lowest prices per se. When you locate relatively undervalued, undiscovered, and underappreciated areas, price increases will surely follow.

5

HOW TO FIND BARGAIN-PRICED PROPERTIES

When stockbrokers and financial planners compare the profit potential of property to stocks, they err in many ways. They ignore leverage; they omit cash flows from rents; they fail to understand the gains achieved through entrepreneurial research and talent. And they miss the fact that (unlike with stocks) you can buy property at a price less than its current market value.

If Wal-Mart stock sells for $20 per share, you will pay $20 per share. No one will sell for less. The same principle applies for every stock from Apple to Xerox.

In contrast, if you want to pay $200,000 to $225,000 for a property that's valued at $250,000, you can find sellers who will oblige. In fact, one popular axiom of real estate goes like this, "In real estate, you not only make money when you sell, you can make money when you buy." Although you do not really "make money" when you pay less than market value, you do fast track your profit potential.

WHY PROPERTIES SELL FOR LESS (OR MORE) THAN MARKET VALUE

Recall from Chapter 3 that a *market value* sale specifies these five criteria:

1. Buyers and sellers are typically motivated. Neither acts under duress.
2. Buyers and sellers are well informed and knowledgeable about the property and the market.

3. The marketing period and sales promotion efforts are sufficient to reasonably inform potential buyers of the property's availability (i.e., no forced or rushed sales).
4. No unusual terms of purchase (e.g., low-down seller financing, all cash, below-market interest rate) apply.
5. No unusual concessions are made by either the seller or the buyer (e.g., sellers are not permitted to stay in the house rent free for three to six months until their under-construction new house is completed, buyers' offer contingent upon the sale of their current residence).

Owners who sell in a hurry may have to accept a price lower than market value. Likewise, a FSBO (someone who sells "for sale by owner") who doesn't know how to market and promote a property will not likely receive top dollar. Or say the sellers live out of town. They don't realize that recent sales prices have jumped up, or maybe they don't realize that their property (or the neighborhood) is ripe for profitable improvement.

Owners in Distress

As news stories so vividly report, every day people hit hard times. They lose their jobs, file for divorce, suffer accidents or illness, experience setbacks in their business, fall behind on their car loans, credit cards, and mortgage payments, and get hit by a freight train of other problems. Any or all these calamities can create financial distress. For many of these property owners, their only way out of a jam is to raise cash by selling their property fast at a bargain price.

Some investors find it distasteful to prey on the down-and-out. Yet owners who find themselves in financial distress long to get rid of their sleepless, toss-and-turn nights. If that means selling their property for "less than it's worth," then that's what they're willing to do. These people do not just sell a property; they buy relief.

Under such circumstances, when the sellers believe they have gained more from a sale than they've lost, both parties win. If you want to help people cope with adversity—as opposed to fleecing them—seek out distressed owners who will give you the bargain price (or favorable terms) you want.

The "Grass-Is-Greener" Sellers

One day Karla Lopez is sitting in her office, and in walks the executive vice president of her firm. "Karla," she says, "Aaron Stein in the Denver branch just quit. If you want his district manager's job, you can have it. We will pay you $40,000 more a year plus bonus. But you have to be relocated and on the job within thirty days."

"Do I want it?" Karla says. "Of course I want it. A promotion like this is why I've been working seventy-hour weeks for these past four years."

Think about it. In this situation, does Karla think, "Well, the first thing I must do is put my house up for sale and go for top dollar?" Hardly. More than likely, Karla wants to strike a deal with the first buyer who gives her any type of offer she can live with. Karla has her sights set on the greener grass of Denver. Optimistic about her career and facing a time deadline, Karla wants to get her home sold as quickly as possible.

Grass-is-greener sellers stand opposite to the financially distressed. Whereas distressed owners sell on bargain terms or price to relieve themselves of pain, grass-is-greener sellers will accept an offer of less than market value so they can quickly grab better opportunities that lie elsewhere.

On one occasion when I was a grass-is-greener seller, I not only gave my buyers a slight break on price, but more importantly from their perspective, I let them assume my below-market interest rate first mortgage and carried back an unsecured note for the amount of the difference between the price they paid and the outstanding balance on the mortgage they assumed (i.e., they bought with nothing down and below-market terms). On various occasions, I've bought from sellers who were eager to pursue better opportunities elsewhere. Each time, I negotiated a good (if not great) price and favorable financing.

If looking for distressed owners doesn't appeal to you, turn your search in the opposite direction. Sellers who want to move to greener pastures (especially under a deadline of time) are frequently the easiest people to work with and the most accommodating in price and terms.

Stage-of-Life Sellers

When shopping for below-market price deals, find bargains among stage-of-life sellers. These sellers include owners whose lifestyle now conflicts with their property. They may no longer enjoy a big house or yard, collecting rent, or dealing with tenant complaints. They eagerly anticipate their move to that condo on the 14th green at the Bayshore Country Club. Or perhaps they would rather not go through the trouble of updating and repairing their current property. Whatever their reasons, stage-of-life sellers are motivated to get on with their lives.

In addition—and this fact makes these sellers good prospects for a bargain price or terms—stage-of-life sellers have typically accumulated large amounts of equity in their properties. And because they're older, they may have substantial sums in savings or other investments. Stage-of-life sellers are open to offers. They don't need to squeeze every last penny out of their sale—or pocket all cash from the deal. Because stage-of-life sellers often do not face a pressing need for cash, they make excellent candidates for OWC (owner will carry) financing. Not only will OWC terms help them sell their property more quickly, but an installment sale reduces or defers the capital gain taxes that a cash sale might otherwise trigger (if the property does not qualify for the principal residence tax exclusion benefit; see Chapter 14). As another advantage, OWC financing—even when offered at below-market interest rates—will often net the sellers a higher cash income return than they could earn in a savings account, certificate of deposit, bonds, money market fund, or stocks.

Case in point: As a college student who wanted to invest in real estate, I sought stage-of-life owners of rental properties. These people were tired of managing their properties. Yet, they valued a monthly income and (most) didn't want to settle for the meager interest paid by banks or the low-income yield and big risks of stocks. They also didn't want to sell their investment properties and get hit with a tax bill for capital gains.

Their solution: Sell on easy OWC terms to an ambitious young college student who was willing to accept the work of rental properties in exchange for an opportunity to start building wealth through investment real estate. This opportunity remains today. Because properly selected, well-managed rentals will pay for themselves, if you are willing to work, you can substitute ambition and perseverance for a large down payment and high earnings.

Seller Ignorance

Some sellers underprice their properties because they don't know the recent prices at which similar properties have been selling. Or they do not know of a unique advantage that favorably distinguishes their property from others. I confess that as a seller, I have made the mistake of selling too low because I was ignorant of the market.

Some years ago, I lived in Palo Alto, California. The rental house I decided to sell was located across the country. A year earlier, this house had appraised for $110,000, which at the time of the appraisal was about right. So I decided to ask $125,000. I figured that price fair and still left some room to negotiate.

The first weekend the house went on the market, three offers came in at my asking price of $125,000. Immediately, I knew I had underpriced. What I had not known but soon learned was that during the year I'd been away, property prices in that neighborhood had jumped 30 percent. After learning of my ignorance, I could have rejected all the offers and raised my price. Or I could have put the buyers into a bidding war. But I didn't.

I decided to sell to the person with the cleanest offer (no contingencies). I was making a good profit; why get greedy? In addition, at that time I was teaching at Stanford University, writing a book, and consulting for Wells Fargo Bank. In other words, I did not want to give this property sale much attention. So, in part, my grass-is-greener-in-California attitude also contributed to my desire to go for the quick dollar rather than top dollar.

Sellers sometimes mistakenly and sometimes intentionally underprice their properties. Stay on the lookout for this possibility. When you spot a good deal, jump on it. Underpriced properties often get snapped up quickly.

Although good deals go fast, not all bargain-priced properties represent good deals. You receive a good deal only if you can sell the property for substantially more than you have put into it. Watch out for long-term declining markets where a seemingly low price today morphs into an even lower price tomorrow. Also, accurately calculate fix-up expenses, hidden defects, and environmental problems (e.g., lead paint, underground oil storage tanks, asbestos, contaminated well water). Ration your cash. Keep your improvements in line with the rent levels your prospective tenants are willing and able to pay.

Temper your eagerness to buy a bargain-priced property with a thorough physical, financial, market, and legal analysis. Go slowly for low- or nothing-down seller financing. Delay the temptation to jump without looking. First put on your Sherlock Holmes hat. Act quickly—with caution. The less you know about a property and the more you assume, the greater your risk. Balance eagerness to buy with an explicit and realistic view of potential pitfalls. *Prepare* to buy before you buy.

PREPARE SCREENING CRITERIA

Select properties to bid on in an area. Even if you could, you would not buy every property (bargain-priced or not) that strikes your attention. Before you move to the "buy" stage, narrow your choices:

What neighborhoods look promising?

Do you want a single-family house, condominium, co-op, town house, or multi-unit rental property? If multi-units, how large a property will you accept?

Would you prefer to occupy and invest simultaneously? If owner occupancy is important, how does this fact limit your choice of neighborhoods and properties?

How much repair, renovation, or remodeling work are you willing and able to take on?

What types of improvements will you try? Structural? Cosmetic? Environmental? Fire damaged? Earthquake damaged? Other?

Which is most important: a bargain price or bargain terms? Would you buy a property with negative cash flows? If no, what is your minimum cash-on-cash return on investment?

Would you accept a property occupied by problem tenants?

How much risk will you tolerate? When buying fixer-uppers, your repairs and renovation costs may exceed your estimates. If you buy into a turnaround neighborhood, the turnaround may take longer than you expect.

How much cash or borrowing power can you draw on to carry you through a period of impaired rent collections (vacancies, bad tenants)?

What's the minimum time period you would accept on a balloon mortgage or other short-term financing?

How long do you plan to own the property? When all costs are considered, will the property command a selling price or rent level high enough to meet your profit objectives?

What are your profit objectives? What sources of return seem possible with this property?

Focus on properties that match your requirements. Eliminate the wild-goose chases that steal the time of many beginning real estate investors. Clarify goals and circumstances. Resist the temptation to grab a deal just because it is a deal. Go after those properties that suit your abilities, finances, and inclinations.

BARGAIN SELLERS

Now that you have developed your screening criteria, how do you start finding potential sellers?

Networking/Get the word out
Newspapers and other publications
Cold call owners
Agent services
Internet listings

Networking/Get the Word Out

Some time back, I was leaving the United States for several years and decided to sell my house with a minimum of hassle. Coincidentally, the Ph.D. student club at the university where I was teaching was looking for a faculty member to host the upcoming faculty-student party. "Aha," I thought—what better way to expose my house to more than 100 people? So I volunteered. In the week following the party, I received two good offers and accepted the best.

The buyers received a good price and excellent financing. I avoided the hassle of putting the property on the market and did not pay a sales agent. Win-win for buyers and seller.

Draw on the power of networks. Yet, few buyers and sellers consciously try to discover each other through informal contacts among friends, family, relatives, coworkers, church groups, clubs, business associates, customers, parent-teacher groups, and other types of acquaintances. Make your search common knowledge. Tell everyone you know. Describe what you're looking for.

Why search alone when you can enlist dozens of others to help you? Nearly all property owners prefer a quick direct sale—even at a lower than market price. Like me, they prefer to bypass the hassles and costs of listing and selling through a realty firm.

In addition, network searches often awaken sleeping sellers—owners who are open to offer, but for various reasons are not yet marketing their property(ies). Indeed, right now I am a sleeping seller on a property located in North Carolina.

Newspapers and Other Publications

Some investors browse the real estate classified display and ads with a highlighter, then call owners or Realtors, obtain cursory information, and when a property sounds promising, set up an appointment to view it. This method might work, but it can fail for two reasons: (1) If a property isn't advertised, you won't learn about it; and (2) you may pass by ineffectively written ads—even though the property itself might actually deserve your attention.

The solution: Run your own advertisement in the real estate "wanted to buy" column. Describe the type of property and terms that you seek. You will invite serious sellers to contact you. When I began investing, I used this technique to locate about 30 percent of the properties I bought.

As another way to use the newspaper, read the "houses for rent," "condos for rent," and "apartments for rent" ads. This research helps you gauge rent levels. You will also see properties advertised as "lease-option" or "for rent or sale." These kinds of ads generally indicate a flexible and motivated seller.

When you search for bargain sellers, look beyond the real estate classified ads. Identify potential sellers from the public notices: births, divorces, retirements, deaths, bankruptcy, foreclosure, or marriage. Each of these events can trigger the need to sell real estate. If you contact these potential sellers before they list with a sales agent, you stand a fair chance of buying at a bargain price. (In addition, subscribe to your area's "default" or "foreclosure" newsletters published in print or via the Internet. Chapter 6 tells you how to profit from foreclosures.)

Cold Call Owners

To cold call productively, adopt the Realtor technique and cultivate a neighborhood farm. Many top-selling realty agents select a neighborhood (or other geographic area) and cultivate relationships to find sellers who will list their properties for sale with that agent. Agents telephone property owners from names listed in a crisscross directory, walk the neighborhood, talk with residents, circulate flyers by mail or door-knob hangers, and participate in neighborhood or community-sponsored events. By cultivating a neighborhood farm, an agent becomes known in the area. He positions himself as the first person property owners think of when they decide to sell their house.

You can beat the agent at his own game. Cultivate your own neighborhood (or community) farm. Among residents and businesses, circulate a flyer that reads:

> Before you list your property for sale, please call me. I plan to buy a property in this neighborhood directly from the owners. Let's see if we can sit down together and work out an agreement that will benefit both of us.

When property owners learn how they can save time, effort, and money selling direct, they may offer you a favorable price or terms. Also, if you get to them before they talk with an agent, they may even quote you a below-market price because they lack reliable market comp data. (Of course, uninformed sellers may also quote you an above-market price—especially if comparable prices are below their previous peaks.)

Vacant Houses and Out-of-the-Area Owners. Your farm area will include some properties (vacant or tenant occupied) that are owned by people who do not live in the neighborhood. These owners may not see your flyers, nor will you find them listed in a crisscross directory. To reach these potential sellers, ask neighbors and talk with the tenants who live in the property.

If this research doesn't reveal the owners' names and addresses, contact the tax assessor's office. There you can learn where and to whom the property tax statements are mailed. It's not unusual to find that out-of-the-area property owners are actually "sleeping sellers" (as I am with my North Carolina property). They will sell but haven't as yet awoken to the idea. You can become their alarm clock.

Broker Listings. For any number of reasons, properties listed with real estate agents do not sell during their original listing period. When this failure occurs, the listing agent will try to persuade the owners to relist with his or her firm. And quite likely, agents from other brokerage firms also will approach the sellers. Here's what you can do to cut them off at the pass and perhaps arrange a bargain purchase.

When you notice a listed property that looks as if it might fit your requirements, do *not* call the agent. Do *not* call or stop by to talk to the owners. Instead, write the owners a letter stating the price and terms that you would consider paying. Then ask the owners to contact you *after* their listing has expired. (If a seller goes behind his agent's back and arranges a sale while the property is listed, the owner is still legally obligated to pay the sales commission.)

Consider this possibility: You find a property listed at its market value of $200,000. The listing contract sets a 6 percent sales commission. The sellers have told themselves that they will accept nothing less than $192,500, meaning that after paying the expenses of sale they would net around $180,000. You offer $175,000. Would the sellers accept it? Or would they relist, postpone their move, and hold out for another $5,000 to $10,000?

They just might accept your offer. It depends on their finances, their reason for moving, and any pressures they may face. But you can see that even though your offer is low relative to the market value of the house, it still provides the sellers almost as much as they could expect to net if their agent found them a buyer. (Naturally, your letter would not formally commit you to purchase the property. It would merely state the price and terms that you have in mind.) Also, when you make such offers, emphasize the relative amounts the seller will net—not price per se.

Although agents can provide you services, if you want to buy at a bargain price or buy on bargain terms (especially with low- or no-down-payment seller financing), where is the agent's fee going to come from? To negotiate a bargain price, at times, forego an agent's services and do your own legwork.

Agent Services

As to agent services, investor and renovator Suzanne Brangham wants to rely on them. In her book, *Housewise* (HarperCollins, 1987, p. 163), Suzanne exclaims:

> You need realty agents as much as they need you. After you have narrowed your choice to one or two neighborhoods or towns, enlist the aid of an expert. Your real estate agent will guide you so that you can sit back, take out your notebook, ask questions, and learn. . . . Good agents know what prices properties are selling for, which areas are strong, and which neighborhoods are getting hot. . . .
>
> If you let your agent know that you plan to buy and sell several properties over the next few years, he (or she) will do everything short of breaking and entering to show you the properties that are available. . . . I'd been lusting after a beautiful two-unit building, but it had never been up for sale. My agent called me the minute it was listed and I bought it in less than an hour. In fact, I soon became notorious for signing offer forms on the roof of my agent's car. When there's a race to get in your bid on a particularly juicy piece of property, a faithful agent who knows exactly what you want can make all the difference.

Although my experience with agents does not reach the gushing praise that Suzanne extols, a skilled agent can assist you with at least eight helpful tasks:

- Suggest sources and techniques of financing and help you run through the numbers.
- Research comp sales and rent levels so that you can better understand values.
- Act as an intermediary in negotiations.
- Recommend other professionals whose services you may need (lawyer, mortgage broker, contractor, designer, architect, property inspector).
- Handle innumerable details and problems that always seem to pop up on the way from contract to closing.
- Clue you in about what type of interest and market activity has developed around various properties.
- Give you an insider's glimpse into an area to let you know who's doing what and where.
- Disclose negatives about a property or neighborhood that might otherwise have escaped your attention.

Agents will sort through your neighborhood and property trade-offs, suggest possibilities for value-creating improvements, and try to persuade sellers to accept your price and terms. The best agents, as Brangham points out, "[are] those who listen when you explain what you are looking for. They will take you directly to the buried treasure you want to find."

Civil Rights Caveat. Real estate agents (like everyone else) must constantly guard what they say out of fear of lawsuits alleging discrimination. If you ask, "What's the quality of the schools in this neighborhood?" the agent may hedge an answer if, say, at one time school busing or racial strife spurred exodus to suburbia, and correspondingly, student achievement test scores fail to meet acceptable levels.

Likewise, if the ethnic, religious, or racial composition of a neighborhood affects property values (either up or down), a sales agent would not mention this fact. The U.S. Department of Justice (DOJ) and the U.S. Department of Housing and Urban Development (HUD) have decreed that neither ethnic, religious, nor racial demographics affect property values.

Real estate agents (or property appraisers) who disagree with HUD or the DOJ can find themselves liable for civil and/or criminal penalties—including monetary damages, fines, and even prison. When your inquiries clash with fair housing mandates, do not expect straight talk from your realty agent.

Property Condition Caveat. In addition to fair housing issues, most agents tread lightly in response to questions about the condition of a property. "How's the roof?" you ask. The agent answers, "As far as I know, it's eight years old and hasn't had any leaks." You buy the property, and three months later the roof begins to leak. On the basis of the agent's statement, you sue the brokerage firm for misrepresentation and fraud. Even though the agent told the truth as far as he or she knew it, many judges or juries would find the agent liable.

Buyers have sued agents so many times for giving "to the best of my knowledge" answers concerning property condition that smart agents avoid such questions. They prefer to refer you to appropriate property specialists and inspectors. In one major precedent-setting case in California, a realty agent was held liable for not informing his buyers that a property was located in a mud slide area—even though the agent did not know that the area was risky. In response to this case, the California Association of Realtors convinced the California legislature to enact a *seller disclosure* law. Most other states have followed California's lead.

To buy at a (true) bargain price, rely on accurate information about neighborhoods and properties. A top real estate agent will provide you with some of these data, but not all that you need. Recognize the practical and legal limits that restrain even the most knowledgeable agents.

Buyer Loyalty. For every real buyer they work with, most agents encounter a dozen pretenders—wannabe investors who steal an agent's time and knowledge but feel no obligation to buy from that agent. Or if they do buy, the first thing they do to make a deal work is to try to cut the agent's commission. Such an approach does not build a relationship. To gain the benefits Suzanne Brangham celebrates, demonstrate buyer loyalty.

Show loyalty to your agents, and in turn, they will favor you as a client who gives them repeat business (as well as referrals). In return, they provide top service and include you among the first to learn of those "juicy deals" as soon as they hit the market—and sometimes even before a listing goes into the MLS (Multiple Listing Service).

Internet Listings

Property investors not only cruise neighborhoods, they cruise the Internet to look for properties. Thousands of web sites now list properties for sale. Property buyers (or browsers) can directly access the Realtors' Multiple Listing Service (MLS) at www.realtor.com.

A huge entrepreneurial industry of content providers publish specialized listings of everything from foreclosures to commercial properties to FSBOs. Online, you can locate investors looking for money—or money looking for properties. Nearly all real estate information that in the past has been available from Realtors—government records, newspaper ads, newsletters, and other sources—is now (or will soon be) accessible. Electronic shopping for real estate (and mortgages) has rendered the MLS book as obsolete as a slide rule. In addition to the web sites referenced in this book, search engines can guide you to a cornucopia of useful data and topical discussions.

SELLER DISCLOSURES

What you see is not all that you get. That below-market price won't seem like such a great deal once you learn the roof leaks, the foundation is cracking, and termites are munching on floor joists for their dinner. Moreover, if the next-door neighbors make Animal House look tame, quality tenants will not rent your property—or if they do move in, they will not stay.

Prepare against such unwanted surprises. Thoroughly inspect the property, talk to existing tenants, walk the neighborhood, and avail yourself of knowledgeable and trustworthy real estate agents. Get the property checked out by a property inspector, a structural engineer, a pest control expert, or other specialists who accurately assess the condition of the property. And last but not least, ask the sellers to complete a seller disclosure statement.

The Disclosure Revolution

More than 40 states now require (or encourage) sellers to complete a seller disclosure statement that lists and explains all *known* problems or defects that may plague a property. But even if your state doesn't yet mandate seller disclosure, obtain a disclosure form (most realty firms keep blank copies on hand) and ask the sellers to fill it out. (Or google "seller disclosure statements." Your hits will include blank forms from multiple states.)

As you review a seller-completed disclosure statement, watch for these five issues:

1. Sellers cannot disclose facts or conditions of which they are unaware. Disclosures do not substitute for inspections.
2. Disclosures reveal the known past. They make no guarantees. Sellers do not warrant the present or future condition of the property. They report only what they know.
3. Disclosure questions permit subjective answers. Are playing children a neighborhood "noise" problem? Is a planned street widening an "adverse" condition?
4. Disclosure statements may not require sellers to disclose property defects that you can readily see. Keep your eyes attentive.
5. Beware of seller (or agent) statements that begin, "I believe," "I think," "as far as we know," and other similar hedges. Do not accept these answers as the final word. Follow up hedged statements or assertions with definitive inquiry or inspection.

Seller disclosures help you accurately understand and value properties. But even so, give them only as much weight as they deserve. Independently check out the property to verify that you know what the property is worth more than the price you are agreeing to pay.

Income Properties

Some seller disclosure laws apply only to one- to four-family owner-occupied properties. If you buy an apartment building or shopping center, the law may not require the seller to fill out a disclosure statement. If, in this situation, the seller refuses, offset this additional risk by scaling down the price you offer—and enhance the rigor of your pre-purchase inspections.

Verify rental income and operating expenses. Ask the sellers to sign a statement whereby they swear that the income and expense figures that they have reported to you are true and factual. Some owners place friends, relatives, and employees into their buildings at inflated rent levels. These tenants do not pay the rents shown in the lease (or if they do, they get kickbacks in cash or other benefits), but their signed leases sure look attractive to unsuspecting buyers.

SUMMARY

To find owners who will sell at a below-market price is like panning for gold. Even when you know a stream is loaded with potential, you will probably sift through a ton of muck and rock before you discover the nuggets that yield the profits. When searching for below-market deals, expect to work. As you gain experience and reputation, deals will start coming to you. But as stock speculator Gordon Gekko (Michael Douglas) tells Bud Fox (Charlie Sheen) in the movie *Wall Street,* "Kid, I look at 100 deals a day. I may choose one." Prepare yourself.

Among the properties that sellers (or agents) promote as bargains, many turn out otherwise. Through skillful negotiation and financial structuring, you can sometimes transform an apparently mediocre deal into a winner. Except in cases of luck, putting gold nuggets into your pocket will require intelligence, knowledge, and possibility thinking. But like the industrious and fortuitous miner who pans for gold, those bargain-priced properties you do find will generously reward you for your diligence.

6

PROFIT WITH FORECLOSURES

For the past several years, the news media have given the topic of foreclosures more pages of coverage than at any time since the early 1930s. In the beginning of this current financial downturn, journalists positioned their foreclosure stories in terms of human hardship. "Greedy bankers ruin lives."

More recently, stories highlight the extraordinary (one could almost say "chance of a lifetime") opportunities that many of today's property markets offer (especially foreclosures/REOs).

But as with all property investing, foreclosures present pitfalls as well as potential. Do not fall for the "easy money" media stories or the inflated "pennies on the dollar" claims of the foreclosure gurus.

To profit big with foreclosures—and at the same time steer clear of big risks—requires you to gain knowledge of the foreclosure process, market research, valuation, reliable "cost to cure" estimates, and the power of persuasion. Develop your talents within each of these skills and today's market will present you with more good possibilities than any market I have experienced throughout my career. The low risk/high reward foreclosure opportunities are best captured by investors who prepare.

THE FORECLOSURE PROCESS

Borrowers default because they fail to make their mortgage payments. But defaults also occur when owners fail to pay their property taxes; fail to pay some related obligation (homeowners' association fees, a superior mortgage claim, special assessments); transfer a mortgaged property without lender approval; or undertake renovations, remodeling, or demolition that diminish the value of the property.

Lender Tries to Resolve Problem

In contrast to the late 1980s and early 1990s, most lenders today give delinquent borrowers generous opportunity to restructure, reinstate, or refinance their mortgages. That's why even though the number of mortgages in default is now approaching six million, the number of properties actually sold at foreclosure auctions comes in below two million. With more loan workouts, a smaller percentage of troubled borrowers lose their properties via a foreclosure sale. Nevertheless, mortgage lenders (or guarantors) will get the keys to more than one million properties this year. And the number of borrowers who have fallen behind in their payments (and thus are in need of a workout) now exceeds 4 million. Given these huge numbers, the foreclosure business (preforeclosure workouts including short sales, government foreclosures, and postforeclosure REOs) provides a cornucopia of profit potential.

Filing Legal Notice

When a lender finally gives up on a preforeclosure workout, its lawyers file either a legal "notice of default" or a "lawsuit to foreclose" (depending on the state). This legal filing and its subsequent posting of notice on the Internet or in newspapers formally announce to (1) the property owners, (2) any other parties who may have legal claims against the owners or their property, and (3) the public in general, that legal action is moving forward to force a "courthouse" sale of the property.

At least one month passes between the date of legal filing and the foreclosure sale. More typically, this waiting period ranges between 60 and 180 days. If the property owners file a legal defense to the lender's foreclosure action (e.g., lender violated due process, fraud, consumer rights, truth in lending), the foreclosure sale may have to wait for a lender victory in settlement or trial. These kinds of litigation battles can drag on for a year, two years, or even longer. The sheer volume of defaults today is also extending the period between the date of the original default and the actual day of the foreclosure sale. Lenders and mortgage servicing companies lack the personnel necessary to steer a defaulting borrower into foreclosure (or workout) in a timely manner. In addition, to halt the foreclosure sale for *at least* a month or two longer, defaulting property owners sometimes file for bankruptcy. Bankruptcy filing by the property owners immediately and automatically stays a foreclosure action. To proceed further in its efforts to force a sale, the lender petitions the bankruptcy court. Only after the court grants permission will the foreclosure process start running again. (In fact, in some situations, a bankruptcy court can annul a foreclosure sale that has already occurred.)

The Foreclosure Sale

Eventually, when defaulting property owners run out of legal defenses or delaying tactics, the foreclosure sale date arrives. At this point, the property is auctioned to the highest cash bidder. Sometimes a real estate investor (foreclosure specialist), speculator, or even a homebuyer submits the winning bid. More likely, the lender who has forced the foreclosure sale bids, say, one dollar more than the amount of its unpaid claims (mortgage balance, late fees, accrued interest, attorney fees, foreclosure costs) and walks away with a sheriff's deed to the property. Next, the lender eventually sells the property directly through a real estate brokerage firm, or in troubled times like these through some type of auction sale where dozens—or even hundreds—of REO properties meet the rap of the auctioneer's gavel.

REOs

Remember these words: LENDERS DO NOT WANT TO OWN FORECLOSED REAL ESTATE. For a lender (or institutions such as the Federal Housing Administration [FHA], Department of Veterans Affairs [VA], Fannie Mae, Freddie Mac), holding onto an REO that has been acquired through foreclosure rarely seems like a good idea. No matter how much potential the property offers, owners of REOs want to sell quickly. Lenders expect to lose money on their sales of REOs—but they would lose even more by holding onto these properties. Lenders find themselves quite ill-suited to operate as property management companies.

Therefore, to profit with foreclosures, pursue one or more of these three approaches:

1. Negotiate with the distressed property owners and, if necessary, the foreclosing lender (i.e., to obtain a short sale or refinance).
2. Bid at the foreclosure auction.
3. Buy an REO from the lender or the "insuring" agency (FHA, VA, Fannie Mae, Freddie Mac) that owns the property. (This topic is covered in Chapter 7.)

BUY PREFORECLOSURES FROM DISTRESSED OWNERS

Each year in every community, hundreds (sometimes thousands) of property owners hit the financial skids. Divorce, job loss, accident, illness, business failure, payment shock (ARMs), and other setbacks render people unable to make their mortgage payments. Rather than effectively deal with their problems as soon as default is imminent, most owners hang on too long, hoping for a miracle to bail them out. Since miracles are rare, most of these people end up staring foreclosure in the face.

At that point, you may be able to help them salvage their credit record and part of their home equity and at the same time secure a bargain for yourself. Faced with pressures of time and money, distressed property owners accept a quick, credit-rescuing sale at a price less than market value.

Approach Owners with Empathy

No one can give you a magic system to buy property from people who face foreclosure. These owners must contend with financial troubles, personal anguish, and indecisiveness brought on by emotional depression. They have probably been attacked by foreclosure sharks, speculators, bank lawyers, and recent attendees of get-rich-quick foreclosure seminars. These owners live with the public shame of failure. For all these reasons and more, they are not easy people to deal with.

To succeed, develop a sensitive, empathetic, problem-solving approach. Think cooperation. Think win-win. You gain a bargain price. The sellers will shed their burdens and limit their potential losses. To find and persuade sellers, you compete against foreclosure specialists. A "Here's my offer—take it or leave it" approach antagonizes the owners. It does not favorably distinguish you from a dozen other potential buyers (sharks). Design your negotiations and offer to preserve what little may be left of the owner's dignity and self-esteem. Share personal information about setbacks you have lived through. Emphasize win-win outcomes. Dire straits or not, no one wants his or her home (property) stolen away.

The Difficulties of Dealing Profitably with Owners in Default

Some "get rich in foreclosures" seminars, CDs, and books exaggerate the possibilities of profiting from property owners who face foreclosure. The enticing scenarios imagined by these promoters place you in the picture with high-equity sellers who hold a nonqualifying assumable mortgage. You offer the sellers a few thousand dollars in cash and agree to make up their past-due mortgage payments. The sellers deed you their property and move out. You then put a tenant in the property, collect rents, and pay the property expenses and scheduled mortgage payments. Or, alternatively, you fix up the property, put it on the market, and sell for a fat profit. Regardless of which strategy you choose, buying foreclosures can make you wealthy fast—at least that's the pitch of the foreclosure gurus.

Admittedly, such easy pickings are great when you can find them. As you might expect, though, deals rarely move forward with step-by-step simplicity. When you talk with property owners in foreclosure, you uncover a minefield of problems that you must crisscross with skill and creativity. Here are some of the issues you will need to deal with.

Mortgage Debt Exceeds Market Value. Property owners who contend with foreclosure often owe more than their properties are worth. To make a deal work, you must talk the lender into a "short sale"; that is, the lender voluntarily reduces the balance due on its loan so that you receive a "fair" profit for agreeing to make up past-due payments and take over the loan.

Today, increasing numbers of lenders do accept short sale investors, but you must thoroughly prepare your short sale package. Then you wait, suffer runarounds, and sometimes lose the deal to a higher bidder.

Nonquals Are Tough to Find. Few mortgages today automatically permit assumptions. Finding a homeowner in foreclosure who actually has a nonqualifying assumable is like finding the proverbial needle in a haystack.

Qualifying Assumptions Are Limited. Today's FHA and VA mortgages do permit assumptions, but only by credit-qualifying owner-occupants. If your credit or income is shaky, or if you plan to "flip" the property without taking occupancy or hold the property as a rental, neither FHA nor VA will let you assume an existing mortgage.

Multiple Creditors, Multiple Title Problems. Property owners who suffer foreclosure often get hit by claims of other creditors. Check to see if one or more of these creditors has filed a *lis pendens*, a tax lien (Internal Revenue Service or other taxing authority), or has secured a judgment against the homeowners. To clear title, you may have to clean up and settle with several creditors—not just one mortgage lender.

Workout with Credit Counselors. Most lenders today (especially FHA, VA, Fannie Mae) encourage financially troubled property owners to seek credit counseling and loan workout with nonprofit agencies such as CCCA (Credit Counseling Centers of America). Neither the homeowners nor the lenders may need a profit-minded workout specialist. The new "foreclosure rescue" program that Congress enacted will also compete to a degree with profit-motive investors.

Save Equity through Bankruptcy. In many states, homeowners can file bankruptcy and save all or part of their home equity. Fifteen or 20 years ago, only the most bold or financially ruined Americans pursued bankruptcy. Now, bankruptcy serves as just another tool of financial planning. Approximately 1.5 million couples and individuals elect to file for bankruptcy each year.

When someone can get rid of all those credit card balances and unpaid medical bills—and at the same time save their most valuable asset (their home equity)—why let a foreclosure investor come through the door?

Note: In 2005, Congress passed a revised bankruptcy law that intends to make debtors pay back more of the money they owe as well as to tighten the bankruptcy homestead exemption. Because bankruptcy combines both state and federal law, talk with an attorney in your area. My guess is that this tightening of bankruptcy law will increase your opportunities for profitable preforeclosure workouts.

Bankruptcy Doesn't Ruin Credit. The threat of "ruined" credit doesn't instill the same fear in Americans today that it did two decades ago. In fact, it's not easy to actually *ruin* your credit. After a bankruptcy discharge, people with steady jobs can shortly thereafter obtain credit cards (albeit secured), car loans, and home loans (e.g., lease option, seller financing). After bankruptcy, with two years of clean credit, FHA, VA, and sometimes even Fannie Mae/Freddie Mac lenders will approve reestablished borrowers. The somewhat easy credit-rebuilding techniques reduce the probability that you can persuade homeowners to transfer a large chunk of their home equity to you so that they can "save their credit." (In decades past, a bankruptcy or foreclosure would turn a debtor into a credit leper—no longer does this shunning occur.)

Estimate Repair and Renovation Costs. Before you finalize a preforeclosure purchase with a property owner, thoroughly inspect the property and accurately estimate the costs of necessary repairs, renovations, and perhaps environmental cleanup. In their enthusiasm to do a foreclosure deal, unsuspecting buyers gloss over the inspection and make only an eyeball guesstimate of expected costs. Much to their dismay, they soon learn that slick foreclosure sellers can put one over on unsophisticated buyers, just as slick foreclosure sharks may at times take advantage of distressed property owners.

PREQUALIFY HOMEOWNERS AND PROPERTIES

By warning you of some potentially difficult preforeclosure issues, I do not intend to discourage you. Rather, I want to educate you. Investors who close their minds to facts rarely earn long-term (or even short-term) profits. You *can* gain outstanding rewards through foreclosures—but only if you prequalify the homeowners and the property. Before moving forward toward a workout, evaluate your possibilities and probabilities. Answer these eight questions:

1. What amount of equity have the owners built up in their property?
2. If necessary, will the lender cooperate in a short sale?

3. Will the lender permit you to assume the mortgage? As an investor? As an owner-occupant? At what interest rate? If no assumption, will the lender waive the mortgage prepayment penalty (if any)?
4. Can you satisfy yourself, through a title check or title insurance, that the sellers can convey a marketable title, that is, a title free of consequential clouds (actual and potential)?
5. Will the homeowners work to avoid bankruptcy or foreclosure to alleviate their financial distress? (When sellers refuse to cooperate—as they sometimes do—your chance to succeed drops close to zero.)
6. Would the property owners lose more economically in a bankruptcy than they would stand to gain? (As noted, bankrupts may emerge from bankruptcy with their unsecured debts extinguished and their most valuable assets [IRA, 401(k), home equity, life insurance cash value, furniture, clothing, car] preserved.)
7. Can you *firmly* establish how much you must spend to repair, redecorate, and renovate the property?
8. Is the potential profit margin large enough to justify your investment of time, money, effort, and opportunity cost (i.e., the profits of other deals you pass up to invest in this one)? Complete the following revenue and cost schedule to evaluate risk and profit potential:

Sales price after improvement	$______
Less	
Acquisition price (cash, notes, assumed mortgages)	$______
Mortgage assumption fee	$______
Legal fees	$______
Back property taxes and assessments	$______
Back payments and late fees	$______
Closing costs	$______
Cost of improvements	$______
Holding costs until sold or rented	$______
Miscellaneous	$______
Time and effort (imputed value)	$______
Opportunity costs (imputed value)	$______
Equals	
Profit potential	$______

Do your answers to these eight questions reveal any serious unknowns, uncertainties that magnify risk? Does the amount of profit look high enough to offset cost and market uncertainties? Yes? Then you've created a good deal you should go for.

FINDING HOMEOWNERS IN DEFAULT (PREFILING)

Ideally, learn the names of homeowners who have defaulted on their mortgages before their lender files formal legal notice. Although such discovery can prove difficult, these techniques often work:

Networking

Choose an area that offers potential. Then develop strong networking relationships with some of the people who know the neighborhood, such as mail carriers, delivery truck drivers, school personnel (teachers, principals), social service workers, busybody residents, real estate agents, local merchants, church leaders, and credit counseling personnel. Through this network of contacts, find out who's thinking about selling their home, who's been recently laid off, who spends above their means, who can't pay their bills.

Mortgage Collections Personnel

Some foreclosure specialists develop personal relationships with the lending personnel who collect delinquent accounts. Of course, lenders prohibit their employees from revealing private information about customers. But we all know that what is prohibited and what is practiced can run opposite to each other—especially when "it's just between friends."

An obstacle even greater than privacy now detours this approach. That obstacle is distance. In the good old days, local lending personnel handled a majority of mortgage lending and collections. Today, a mortgage loan in Peoria, Illinois, may be owned by a bank headquartered in San Francisco and serviced by a company located in Boston. When out-of-town personnel deal with the early stages of homeowner default, your chances of nurturing a confidential relationship becomes more difficult.

Drive Neighborhoods

When you really get to know your territory, keep your eye out for properties that appear unkempt, or perhaps suffer a sudden, mysterious, or extended vacancy. Such indicators may signal a property owner who faces financial distress. Ask a neighbor or two to confirm your suspicions.

Informal inquiry may turn up a prime prospect with whom you can negotiate—before a flock of foreclosure vultures land to compete for the pickings.

FIND HOMEOWNERS (POSTFILING)

Once a lender files suit, you can learn the names and addresses of distressed property owners in at least four ways:

1. Visit the clerk of civil court's office and ask to see the list(s) of foreclosure filings.
2. Subscribe to a specialized legal newspaper or e-mail newsletter that reports court filings.
3. Read the "legal notices" section of your local daily (or weekly) newspaper.
4. Go online. Although currently many counties throughout the United States lag behind in the Internet revolution, within a few years even the most backward (or obstinate) will post foreclosure filings on the Web.

As soon as the foreclosure shows up in the public records, competition for quality deals gets heated. To succeed, present yourself and your offer to the distressed property owners in a way that distinguishes you (not merely differentiates you) from the crowd.

Cultivate a Relationship with Property Owners

During periods of stress, property owners often hide the truth about their personal matters. Understandably, the loss of home or property stirs the emotions. As a result, you cannot rely on owner statements. Verify all details about the property and its liens.

Here are several suggested approaches to open negotiations with an owner in foreclosure:

> "If you'll allow me to complete a financial analysis of the property, I can be back within twenty-four hours with a firm offer that might solve your current dilemma."
>
> "I would like to pay you cash for your equity, which you otherwise will likely lose in a foreclosure sale. By working together, we can rescue your credit and you can begin to reestablish your life."

"May I review the loan documents on your home? Can you locate a copy of the mortgage, the title policy, and the monthly loan statements?"

Act faster and offer better results than anyone else. Do not insult or criticize the owners or their property—even though their house may show cosmetic blemishes and deferred maintenance. (In fact, the worse it looks, the better for you.)

As you inspect the property, realistically estimate costs and evaluate its potential market value. You are now prepared to begin discussions of price and terms.

Position your critique as polite inquiry. "Do you think I might have to replace the roof?" "I wonder how I can remove those stains from the carpet?" "Do you think most buyers today prefer the dark kitchen cabinets like these—or the lighter ones like I see in many new model homes?" In this way, you lead the owners to the deficiencies of their property without sharp-edged complaints.

Two More Issues

Up to this point, we have assumed that you were able to: (1) meet directly with the property owners; (2) explore the exact nature of their situation; (3) evaluate the financials of the property; and (4) work through potential win-win-win (owners-lender-you) possibilities. But you may not be able to meet directly with the owners if they are represented by a realty firm, or if they have abandoned the property and relocated away from the community.

Sales Commissions Eat up Owner's Equity. I have found it difficult to work with property owners in foreclosure when they have listed their home for sale with a realty firm. Most run-of-the-mill real estate agents know next to nothing about bank workouts, though I see this lack of knowledge changing. Given the market today, more agents are honing their skills in foreclosure opportunities. Still, rather than help, many do hinder the creative, cooperative process that workouts require.

In addition, real estate agents want to be paid in cash at closing. When a sales agent expects to pull six percent of the sales price—an amount that eats up a large chunk of owner's equity (providing the owner has accumulated any equity), it squeezes your negotiating range. The amount of that commission comes straight from monies that could otherwise go to you, the lenders, or the property owners.

On occasion, I have dealt with savvy agents who understand that if they insist on a full commission they will kill the deal. In one such transaction, the agent agreed to accept just $1,000 in lieu of $4,500. (As this agent realized, he wasn't giving up a fee of $4,500 for a fee of $1,000. Instead he was earning a fee of $1,000 in lieu of earning nothing at all.)

Realty Agents Can Price Too High. Sometimes realty agents hurt the property owners' chance to sell their home when they overprice the listing. Say the distressed owners owe $280,000 on a property with a market value of $300,000. To get the listing, an agent may lead the owners into falsely believing that they can sell the property at a price of $325,000. "Great!" the owners think, "We will net $20,000 to $25,000."

Sixty to 90 days pass, and the overpriced property doesn't sell. The owners panic. The foreclosure lawyers are closing in for the kill. But now the listing is stale. To really grab buyer attention requires a severe price cut to maybe $275,000. By this time, the unpaid mortgage balance along with missed payments and late fees could total $300,000. There's no way a sale will clear out the mortgage debt and the sales commission. More often than not, the foreclosure sale date rushes closer like a speeding freight train.

Quick FSBO Beats Realty Listing. When you talk with low-equity distressed sellers, persuade them not to list with a realty firm in hopes of getting some pie-in-the-sky sales price. Property owners almost always stand a better chance of minimizing loss by going for a quick, discounted FSBO (for-sale-by-owner) sale. In some cases, they should even *pay* someone (cash, note, barter) to take over their loan—or to buy the property and arrange new financing.

Property owners in foreclosure must forget the idea of maximizing gain. Rather, they must eliminate the possibility of severe loss. You must lead distressed property owners to see that time is not their friend. Time is their enemy. The frequently heard homeowner refrain, "We're going to try this for a while and see what happens," does not make sense. What does happen? They lose the property to foreclosure.

Sometimes you fish; sometimes you cut bait. Foreclosure means it's time to cut bait. It's not prudent for property owners to keep throwing the line into new waters. To work successfully with these distressed property owners, repeatedly encourage them to act now. Delay brings regret. Action brings relief.

Vacant Houses

When you discover a vacant house in foreclosure, you discover both a problem and an opportunity. It's a problem because you may have to do some detective work to locate the owners. Unless the owners have purposely tried to disappear, though, you can probably locate them in one of the following five ways:

1. Contact nearby neighbors to learn the owners' whereabouts, or the names of friends or family who would know.
2. Call the owners' telephone number and see if you get a "number changed" message.
3. Ask the post office to provide the owners' forwarding address.
4. Find out where the owners were employed and ask coworkers.
5. Contact parents, friends, teachers, or students at the school the owners' children attended.

After you locate the owners comes opportunity. Because they have abandoned the property, they probably aren't entertaining any fanciful hopes for a sale at an inflated price. At this point, they may view any offer you make them as "found money."

In some cases, you will learn that the owners have split up and gone their separate ways. This type of situation raises another problem: Especially in hostile separations, working out an agreement with one owner in the belief that you can convince the other(s) to go along often proves futile. To avoid this difficulty, bring all owners into the negotiations early. Never rely on, "Oh, she will go along with whatever deal you and I work out."

SATISFY LENDERS AND LIEN HOLDERS

Before you talk numbers in your preforeclosure negotiations, identify who holds legal claims against the property and in what amounts. Ask the property owners for this information. However, do not commit yourself to a deal. Verify the owners' figures through a preliminary title report issued by a lawyer or title insurer. Also verify claims through direct contact with claimants. Your investigation may turn up claimants in the following categories:

Mortgage holders (first, second, third . . .)
Taxing authorities (federal, state, local)
County or city special assessments
Homeowners' association fees and assessments
Unpaid sewage or water bills
Special assessment or bonding districts
Judgment creditors

Mechanics liens for labor or materials provided to the property
Spouse (or ex-spouse) rights, including dower and curtsey
Unfound heirs

One way or another, you will have to decide how you want to satisfy the claimants you find. You can use some combination of the following four techniques:

1. Pay off immediately any or all claimants for the full amount of their claims.
2. Pay off over time any or all claimants for the full amount of their claims.
3. Pay off immediately any or all claimants at a mutually agreed discount.
4. Pay off over time any or all claims at a mutually agreed discount.

Consider a preforeclosure in Phoenix that would likely sell for \$110,000. The owner agrees to deed the property to you if you pay off all outstanding liens, which total \$105,000:

First mortgage	\$78,000
Second mortgage	\$18,000
Roofing contractor	\$3,000
Credit card judgment	\$6,000
Total	\$105,000

Facing these numbers, the deal won't get off the ground. The potential profit margin of \$5,000 is much too low. But what if you could persuade the first mortgage lender to extinguish its old \$78,000 balance and write you a new loan on the property in the amount of \$88,000 (80 percent loan-to-value ratio) and waive all closing costs? You then work out discount deals with the other creditors. After negotiations, your total *payoff* looks like this:

First mortgage	\$78,000
Second mortgage	\$10,000
Roofing contractor	\$2,000
Credit card judgment	\$1,500
Total	\$91,500

By combining \$88,000 in proceeds from the new loan and \$3,500 in out-of-pocket cash, you have just bought a \$110,000 property for \$91,500.

All Parties Are Better Off

If this property had completed its trip through foreclosure, only the first-mortgage lender stood a chance of emerging whole. But more than likely, after adding up continuing lost interest payments, late fees, attorney fees, foreclosure expenses, and REO risks and carrying charges, the first-mortgage lender, too, may have ended up worse off. As for the other parties, here's how they would gain from this workout proposal:

> *The property owners.* Theoretically they lost $5,000 in equity, but as a practical matter, that was $5,000 they were never going to see. Far more important, the workout not only kept a foreclosure entry off their credit record but also rescued them from a possible deficiency judgment.
>
> *The second-mortgage holder.* Again, theoretically the property held enough value to liquidate the full $18,000. As a practical matter, this second mortgagee was better off to take a quick and sure $10,000 and cut its potential losses. Owing to the low prices bid at foreclosure sales, in all likelihood, this lender would have ended up empty-handed.
>
> *Roofing contractor.* Not a chance of collecting any money from a foreclosure sale. (Accepting $2,000 beats nothing.)
>
> *Credit card judgment.* Not a chance of collecting any money from a foreclosure sale. (Again, $1,500 beats nothing. Besides, at this point this debt is probably held by an asset-recovery company who paid less than 5 cents on the dollar to buy the claim.)

In any specific deal, the numbers could come out better or worse for the respective parties—including you. It all depends on the parties' relative negotiating power and skills, their need for cash, their need to avoid risk, and their capacity for understanding. To succeed in the face of this ambiguity, entrepreneurial workout specialists size up people and situations. You have to figure out fast whether a deal looks doable.

Who is willing to settle for how much? Who stands to lose the most? Who needs cash now? Who is willing to wait? What concessions will the first-mortgage lender make, if any? Do the parties understand the likely adverse outcome of a foreclosure sale?

Win by Losing Less

In a foreclosure sale, more often than not, everyone loses except the lawyers. But think what happens when all principals agree to work with—rather than against—each other. You can create an outcome where everyone walks away better off. Maybe they receive less than they hoped for, certainly less than they were theoretically entitled to, but far more than they could expect from a bidder at a foreclosure auction.

PROFIT FROM THE FORECLOSURE AUCTION

Although foreclosure sales typically lose money for lenders, lien holders, and property owners, savvy bidders can turn these sales into big profits. But you must prepare. Bidding blind can buy you problems you do not see.

Why Foreclosures Sell for Less than Market Value

Foreclosure (court ordered) properties sell at prices much lower than their market values. Why? Because court sanctioned auctions do not satisfy the criteria of a market value transaction:

Sale Characteristics

Market Value Sale	Foreclosure Auction
No seller or buyer duress	Forced sale
Buyer and seller well informed	Scarce information
60- to 120-day marketing period	5 minutes or less selling time
Financing on typical terms	Spot cash (or within 24 hours)
Marketable title	No title guarantees
Warranty deed	Sheriff's (or trustee) deed
Seller disclosures	No seller disclosures
Close inspection of physical condition	No physical inspection
Yard sign	Rarely a yard sign
"Homes for sale" ads	Legal notice posting
Sales agent services	No sales agent services

Foreclosure auctions seem purposely designed to sell at the *lowest possible sales price.* They take place under conditions that run contrary to all principles of effective marketing.

Adverse Sales Conditions. The auction sellers (sheriff's office, clerk of court, trustee) provide potential buyers no information about a property other than its legal description. They insist on cash. They offer no "contingency" contracts to allow buyers time to arrange financing. The seller rarely holds an open house or sets up appointments to show the property. Buyers must take the property "as is" with no guarantees or assurances about title quality, physical condition, or environmental hazards. No sales agents offer advice, counseling, MLS listing, or persuasive reasons to buy.

No Guarantee of Vacancy. The foreclosure authorities don't even agree to convey the property free of occupants (owners, tenants, squatters). You may buy a property at a foreclosure auction and spend several months (or longer) to evict the people staying there. Clever occupants use delay tactics. Here are several:

File bankruptcy.
Claim that the foreclosure sale violated due process.
Organize a "people's protest" of some sort.
Continuously make idle promises, "We'll be out by the end of next week."
Seek intervention from some type of child welfare office or other social service agency.
Claim a female in the household is pregnant.
Seek protection under a lease agreement (even though foreclosure sales nullify leases if made after the mortgage on the property was recorded in the public records).
Threaten you or the property with physical harm unless you permit the occupants to stay on for "just a little while."

It's rarely a question, though (in the United States), of *if* you can get the people out—as a rule you can—it's more a question of *when,* and at what cost and effort—and in what condition will you receive the property?

For most would-be buyers, the risk, expense, and aggravation of foreclosure sales deter them from even showing up to bid. When you consider the lame marketing efforts, the adverse conditions/risks of sale, and the potential occupancy problem, is it any wonder that foreclosed properties deserve to sell at a fraction of their market value?

Make the Adverse Sales Efforts Work for You

You might look at the foreclosure sales process and say, "Too many potential problems. No way do I want to take those risks. Besides, how could I ever come up with so much cash on short notice?" That's the attitude of most real estate investors. It explains why at most sales the foreclosing lender "wins" the bid at a price equal to (or slightly above) its outstanding balance.

Overcome the Risks of Bidding. Risk looms large to block your path to foreclosure profits. To bid smart, know as much about the property as due diligence demands.

How can you obtain this information? First, meet with the defaulting property owners to talk over preforeclosure workout possibilities. Even when those discussions end without agreement, you still learn about the property (market value, fix-up needs, improvement opportunities), the neighborhood, and the owner's intentions. This step places you ahead of the game. Second, research the title records. Look for recorded liens and encumbrances, You can research property records in the clerk of court's office or, increasingly, on the clerk of court's web site. If you find no obvious title problems, ask for preliminary opinion of title from a lawyer or title insurer.

Time and Money. To meet with owners and check the title will cost you time, legwork, and perhaps several hundred dollars. Yet, if you buy only one property out of every ten you investigate, you still gain a good payback for your efforts. Just confirm your numbers. Question whether the sales price of the fixed-up property will exceed the total amount of your bid price and fix-up costs by a healthy profit margin.

Inferior Liens Wiped Out. When you buy a property in foreclosure, all liens inferior to the one foreclosed will usually get wiped out. Assume that the first mortgagee is forcing the foreclosure. You win the auction by outbidding this lender by $1,000. The first mortgagee takes what it's owed. The next claim in line takes whatever money is left.

Judgment creditors, mechanic's liens, second mortgagees, tenant leases, and any other claims disappear. Only existing tax liens, special assessments, and perhaps past-due homeowners' association fees may survive. (Lien priority and survival laws differ throughout the United States and throughout the countries of the world.)

For any specific property, discuss the "priority" and "wipeout" issues with legal counsel. But realize that many (if not all) of those preforeclosure liens that clouded the title will vanish. This fact torques up the preforeclosure negotiating leverage that you hold with lienholders. Creditors who don't settle before foreclosure will likely end up with nothing after foreclosure—unless, of course, they also plan to show up at the foreclosure auction and bid.

How to Arrange Financing

After you put together enough information to adequately manage the risks of buying at foreclosure, you face the problem of financing. How are you going to get the cash to close the sale? If you lack wealth or credit, you're probably out of luck. Unless you bring in a money partner, it's difficult to buy at the foreclosure sale.

If you can temporarily raise cash—for example, take out a home equity loan, get a cash advance on a credit card, sell (or borrow against) stocks, or maybe take out a signature loan—you can bid at a foreclosure auction. Then, after the foreclosure paperwork clears, you can place an interim or longer-term mortgage loan against the property (as long as your lawyer or title insurer can clear liens or clouds) and pay off your short-term creditors.

Investors who buy foreclosed properties sometimes establish a line of personal credit at a bank. Then they draw on the money whenever they need it. Or they maintain cash balances in amounts sufficient to cover their usual buying patterns.

THE FORECLOSURE SALE: SUMMING UP

Few real estate investors bid regularly at foreclosure sales. Most prefer to avoid the time, expense, risks, and financing difficulties that foreclosure buying entails. You, too, may agree with this view.

But if you will learn the foreclosure game (as it's played in your locale), do your homework, and manage your risks, you can build profits quickly. You can buy properties at foreclosure auctions for less (sometimes much less) than their market value. Your challenge is to learn which of these properties meet the test of a true bargain—and which ones carry outsized risks, expensive problems, or excessive (upside-down) financing.

Naturally, too, foreclosure opportunities expand and diminish as real estate markets weaken or strengthen. In strong real estate markets, foreclosure bargains become more difficult to locate. In contrast, cyclical downturns like we find today provide boom times for foreclosure buyers. Don't fret about pessimistic news reporting. Prepare yourself mentally and financially to enter and win the foreclosure game.

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PROFIT FROM REOs AND OTHER BARGAIN SALES

As anyone who reads newspapers or watches television knows, banks now hold more than one million foreclosed properties (REOs). In addition, VA, FHA, Fannie Mae, Freddie Mac, private mortgage insurers, and even OWC sellers have taken back perhaps another million houses, condominiums, small apartment buildings, retail stores, mobile home parks, and vacant lands.

Although RTC sales/auctions during the early 1990s created huge REO opportunities in some areas (mostly Texas, Oklahoma, Southern California, and Arizona), today's REO bargains extend more broadly throughout the United States, Canada, and other countries of the world (especially Spain and the U.K.).

Indeed, sales of REOs at distressed prices account for much of the more general drop in property prices. As REOs pile up, even sellers free of financial distress must cut their prices to compete. Likewise for new homebuilders. In many newly built subdivisions, homebuilders' houses now compete directly with the same houses that the builders sold a year or two ago—only at the much lower distressed seller prices.

BAD NEWS FOR SELLERS/BUILDERS, GOOD NEWS FOR YOU

As discussed in the Prologue, bad news for sellers means good news for homebuyers and investors in two ways: (1) You can buy properties today at prices that not only sit 15 to 50 percent below peak prices, but also at prices less than replacement cost. And (2) during the next several years, the high numbers of REOs that now crowd the market will gradually fall back to much lower levels. Their depressing effect on market prices will slow and eventually disappear. Accordingly, until REOs dwindle and property prices climb substantially above replacement costs (the costs of construction), new housing starts will remain well below long-term demand (as supported by growth in population, immigration, household formations, incomes, and jobs).

As emphasized throughout this book, you now enjoy the perfect right time, right price opportunity to buy low and sell for a nice-sized gain within 5 to 10 years (or fewer). Even better, REOs provide these benefits without unusual risks. Unlike a foreclosure auction where you face uncertainty about property condition and title defects, REOs provide a safer alternative. As standard operating procedure, lenders clean up title problems, evict unauthorized occupants, and bring all past-due property tax payments and assessments up to date. REO lenders may also permit buyers to write contingency offers subject to appraisal, financing, and professional inspection. You can buy REOs without fear of nasty surprises.[1]

HOW TO FIND REOs

In desperate times like these, REO lenders often sell REOs through highly advertised auctions. Property agents even organize foreclosure bus trips to tour distressed neighborhoods and properties. (In stable and strong markets, lenders play it low key. No lender likes to publicize the fact that it's "throwing down-on-their-luck families out of their homes.") In addition to big auctions, you can find REOs in two other ways: (1) Follow up after court-ordered foreclosure sales, and (2) locate Realtors who specialize in REO listings.

Follow Up with Lenders after Foreclosure Sales

Attend the sheriff's foreclosure sale. When a lender wins the bid for a property that interests you, buttonhole the bidder and start talking business. Also, visit the REO (loss mitigation) departments of lenders. Show

[1] Several exceptions might include (1) states where the foreclosed owners may have a right of redemption; (2) cases where the foreclosed owners still retain some legal right to challenge the validity of the foreclosure sale; or (3) instances where a bankruptcy trustee or the Internal Revenue Service (tax lien) is entitled to bring the property within their powers. Rarely would any of these potential claims be worth losing sleep over. But before closing an REO purchase, talk over these issues with a real estate attorney.

a lender how your offer saves (makes?) the bank money. If you run into a bureaucratic stone wall, persevere. Today, many lenders do not know what they are doing. Your perseverance may not only reward you with a good property, but more importantly, you'll build personal relationships that open the bank's doors for future transactions.

Sometimes, too, lenders acquire REOs without foreclosure. Lenders occasionally open their morning mail to find the keys to a house, a deed, and a note from the distressed owners, "We're out of here. It's your problem now."

To learn about REOs that lenders now hold in their portfolio of properties, cold call mortgage lenders. Ask for a list of their REOs. Or, rather than ask for a complete list of REOs, narrow your focus. Tell lenders what you're specifically looking for in terms of location, size, price range, floor plan, condition, or other features. In that way, a lender can answer your request without disclosing the full number of REOs within its inventory.

Locate Specialty Realtors

Many mortgage lenders do not sell directly to REO investors for two reasons: (1) As mentioned, they do not want to invite unfavorable publicity; and (2) they do want to promote good relations with Realtors.[2] Because most mortgage lenders expect Realtors to bring them new loan business, the lenders can't then turn around and become FSBO (for sale by owner) dealers. "You scratch my back and I'll scratch yours" sets the rules in this business. Network relations stimulate mutual referrals.

Cultivate relationships with Realtors who specialize in this market. (In fact, HUD, VA, Fannie Mae, and Freddie Mac almost always sell their REOs through Realtors.) In most cities, you can easily find REO specialists by looking through newspaper classified real estate ads and the foreclosure web sites. Increasingly, too, some Realtors are creating foreclosure listing brochures and even office window displays.

Hire a Foreclosure Pro. Once you have identified several advertised foreclosure specialists, call them or stop by for a visit. Learn their backgrounds. Do they only dabble in the field of REOs and foreclosures? Or do they make this field their full-time business? When I telephoned REO specialist John Huguenard in Orlando, Florida, he talked with me for an hour and a half about property availability, detailed financing and

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[2] Also, most lenders don't want to waste time with all of those investor wannabes who have just read a "nothing-down" book or "graduated" from a foreclosure guru's seminar.

purchase procedures, hot areas of town, rehab potential, estimating repair costs, portfolio lenders, strategies for buying and managing properties as well as selecting tenants, and a dozen other related topics.

At one point during our conversation, he asked, "I'll bet you haven't talked to any other agents who know as much as I do about REOs and foreclosures, have you? I've been doing this for twenty-three years. Last year, I sold 90 houses and rehabbed 16 others for my own account."

John is the kind of REO pro you want to work with. When you build a relationship with an agent who's really in the know, you won't have to do your own legwork and door knocking. Your REO agent will screen properties as soon as—if not before—they come onto the market. He will then notify you immediately.

Specialty agents stay on top of the finance plans that portfolio, government, and conventional lenders offer to homebuyers and investors. John Huguenard knew of portfolio lenders doing 100 percent LTV investor loans for investor acquisition and rehab. Tighter underwriting makes such loans more difficult—if not impossible—to find now. But a good REO specialist will know the best loan products available no matter what phase of the credit/property cycle we are going through.

HUD HOMES AND OTHER HUD PROPERTIES

Each year the FHA (Federal Housing Administration), a division of HUD, insures hundreds of thousands of new mortgage loans. (Nationwide, the total number of outstanding FHA mortgages runs into the millions.) FHA loans are originated by banks, savings institutions, mortgage bankers, mortgage brokers, and credit unions.

If borrowers fail to repay their FHA loans, the owner of the mortgage may force the property into a foreclosure sale. Rather than keep the property in its own REO portfolio, that lender turns in a claim to HUD (FHA's parent). HUD then pays the lender the amount due under its mortgage insurance coverage and acquires the foreclosed property. Next, HUD puts the property (along with all the others it has acquired in similar fashion) up for sale to the general public. To see HUD's inventory, go to hud.gov and follow the HUD homes link.

Although HUD is best known for selling single-family houses, it also sells:

- Vacant lots
- Duplex or two units on one lot

- Triplex (three units)
- Fourplex (a four-unit building)
- Condominiums
- Apartment complexes

Homeowners versus Investors

In the contest for HUD homes,[3] HUD favors owner-occupants over investors in two ways: (1) Owner-occupants get the first right to bid; and (2) HUD offers FHA low- or nothing-down insured mortgages only to owner-occupants of 1–4 family properties. HUD does not presently finance HUD homes for those who do not intend to live in the property. (Do not lie to HUD and falsely claim that you plan to occupy a property. Do so and you commit a felony, which HUD will prosecute.)

Given HUD's owner-occupant bias, you might think that homebuyers snap up all of the great buys and investors are stuck with the dregs. On the one hand, that may be true. If as an investor you look for "red ribbon deals" at a bargain price, your HUD pickings might prove few and far between. That type of HUD home typically sells fast at a good price. When HUD homes pile up in an area, your chances go up substantially. On the other hand, if a "fixer" fits your fancy, you can find great HUD buys because first-time homebuyers (HUD's primary market) scare easily.

As one HUD investor told me, "I always look for properties with the highest fear factor. Most homebuyers are afraid of homes that need work. They don't want the risk of cost overruns. They think they lack the knowledge and time to handle the fix-up. And they're right. But I do know how to deal with these things—and that knowledge gives me the advantage to earn good profits through HUD home rehabs for either rental or resale."

"As-Is" Condition

HUD does not warrant the condition of any of the properties that it sells. Even when HUD/FHA offers insured financing, HUD inspects the property for its own benefit only, *not* for the benefit of the buyer.

HUD Recommends Professional Inspections. Because HUD sells its properties "as is," HUD encourages prospective bidders to obtain professional independent inspections *before* they submit a bid. HUD does not accept offers with an inspection contingency. What you see (or don't see) is what you get.

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[3] This section discusses procedures for HUD homes. We address other types of properties later.

However, HUD's refusal to accept inspection contingencies does make buying somewhat risky. Because professional inspections cost $150 to $300, hopeful buyers are expected to incur this fee up front without knowing whether they will actually win the bid.

This fact explains why most first-time buyers avoid HUD "fixers." Inspection fees can easily get wasted. HUD's policy of "as is—no contingencies" favors experienced investors who can accurately estimate fix-up costs and can afford to accept the risks.

Disclosures and Repair Escrows. Although HUD refuses to permit offers with an accept inspection contingency, prior to closing a sale, HUD does allow the winning bidder to run a lead paint assessment on the property if it was built pre-1978. HUD may disclose property defects that it knows about. In some instances, HUD will agree to insure a mortgage for a property only if a buyer agrees to make specified repairs.

None of these actions by HUD cancels HUD's "as is—no warranties" policy. Partial disclosure doesn't mean full disclosure. At HUD, caveat emptor (let the buyer beware) rules.

Potential Conflict of Interest

Although most foreclosure specialists will work to find you a good deal, potential conflict of interest does arise in the sale of HUD properties. First, if you do not submit a winning bid, your sales agent does not earn a commission. An unethical agent could pressure you to raise your bid even if the value of the property doesn't justify a higher price. Second, sales agents may submit bids from competing buyers who bid on the same property. If you bid $80,000, an agent could tell another more favored buyer to bid $80,100. You lose. Third, HUD typically pays brokers who submit a winning bid a 5 percent sales commission plus, on occasion, a $500 (or more) selling bonus for designated properties. Again, this reward may encourage your agent to push you to bid high on a property because she will receive an extra reward.

Although you should not unjustly insinuate that your agent is likely to engage in underhanded sales tactics, it shows good sense to ask your agent how she handles these potential conflicts.

Buyer Incentives

When hard times hit, HUD foreclosures accumulate to unmanageable and costly numbers. To reduce this big inventory of REOs and create quicker sales, HUD may offer buyers easy financing, cash bonuses, and steep discounts. If unsold HUD properties pile up in your area, you might land a particularly good deal.

The Bid Package

As might be expected of a government agency, HUD does not make buying simple. Unlike a private purchase, where you simply write out your offer on any valid contract form, HUD requires a specific contract submission package. Bidders must use only HUD-approved forms and documentation. To bid, complete the required forms, addenda, and enclosures fully and accurately. In addition, your contract package must arrive in HUD's regional office according to HUD's posted schedule.

HUD may (and does) refuse to accept bid packages that do not conform to its instructions. Given HUD's well-known inflexibility, work only with conscientious foreclosure pros who know in detail the ins and outs of HUD's requirements.

DEPARTMENT OF VETERANS AFFAIRS (REOs)

To sell its foreclosed properties, VA follows rules similar to those of HUD. For example, here are 12 major ways the programs resemble each other:

1. The VA sells through a sealed bid process. Likewise, as either a potential homeowner or an investor, you may submit multiple bids during the same bid period.
2. You cannot *directly* negotiate with, or submit a bid to, the VA. You must submit your bid through a VA-approved broker (your foreclosure pro).
3. The VA sells its homes on an as-is basis. Even though it may partially disclose a home's defects, it offers no warranties. Caveat emptor.
4. The VA does guarantee title, and it permits buyers to obtain a title policy.
5. The VA accepts bids that yield it the highest net proceeds (not the highest price). If you agree to pay closing expenses or sales commissions, you can win the bid over others who offer higher prices, but pass these costs (a lower net) on to the VA.
6. Just as HUD/FHA charges FHA buyers an insurance fee, the VA charges buyers who choose its financing a guarantee fee of around 2 percent of the amount financed.

7. The VA accepts bids only on VA forms. If you err in completing the forms, your bid gets tossed out.
8. The VA publicizes its properties through a combination of newspaper ads, broker lists, and Internet postings. You can access VA REOs via the links at hud.gov.
9. Local VA offices report to regional directors, who may issue policies and procedures that differ from those in other regions throughout the country.
10. The VA may choose to keep your earnest money deposit if you fail to close a winning bid for any reason other than inability to obtain financing.
11. As with HUD sales contracts, VA purchase offers do not include a contingency for post-bid property inspections. You may, though, inspect a property before you bid.
12. When necessary, the VA evicts holdover tenants or homeowners before placing a VA property on the market. At closing, you receive the keys to a vacant property.

Big Advantages for Investors

Although the VA follows rules similar to HUD, investors gain more from the VA in two ways:

1. The VA gives equal status to investors. The VA looks for the highest net offered by any credible buyer—homeowner or investor.
2. Unlike HUD, the VA offers financing to investors. At present in my area, for example, investors can close financing on a VA home with total cash out-of-pocket of less than 6 percent of a property's purchase price. In addition, the VA typically applies "relaxed" qualifying standards. VA buyers (who need not qualify as veterans) must show *acceptable,* not perfect, credit records. (For specifics in your area, talk with your foreclosure pro.)

With relatively attractive investor/homebuyer financing, VA homes in good (and even not-so-good) repair sometimes sell at or near market value prices. However, at today's depressed market values, even market value can look good to investors for these three reasons:

1. Leverage permits you to accelerate your wealth-building returns.
2. Even at market value prices, many VA properties pull in rents high enough to provide a positive cash flow from day one of ownership.

3. The VA allows future buyers to assume your VA financing. For investors who want to "fix and flip," an assumable loan makes a great benefit. Plus, when market interest rates go up, a lower-rate assumable VA loan gives your sales efforts a big competitive advantage over other for-sale properties.

VA REOs provide an excellent source of properties and financing for beginning and experienced investors alike. Investigate this opportunity.

FANNIE MAE AND FREDDIE MAC REOs

Fannie Mae and Freddie Mac are the two largest players in the nation's secondary mortgage market. These mortgage companies don't make loans directly to buyers, but they do provide the loan funding for more than 50 percent of the one-to-four family properties that are made by other mortgage lenders.

Sometimes when these loans go bad, Fannie (or Freddie) may force the lender to buy back its loan. Then the primary lender ends up with a foreclosed property in its REO portfolio. Typically, however, lenders who faithfully met Fannie's (or Freddie's) underwriting guidelines can require Fannie (or Freddie) to take ownership of the foreclosed property. (At this time, just in the state of Florida Fannie holds nearly 1,000 properties for sale.)

Agent Listings

Fannie and Freddie do not often use the sealed-bid sales procedure that's common to HUD and VA. Instead, both companies choose a realty firm and give that firm an exclusive right-to-sell listing. The realty firm then places that REO into MLS. The realty agent who takes on responsibility for a foreclosed property first inspects it and then recommends the best way to fix it up to maximize its sales price.

Price to Market. Fannie and Freddie might spend thousands of dollars to recondition and repair a property, and then price that property aggressively. So, typically, you won't buy Fannie or Freddie properties at a steep discount to market value.

But these times are not typical. Fannie and Freddie hold record numbers of REOs that they must sell. Especially in markets hardest hit, Fannie and Freddie are open to offers. Talk with local foreclosure pros. You will likely find some bargains.

First-Time Homebuyers—Special Financing. Fannie and Freddie direct their marketing efforts toward credit-qualified homebuyers (especially first-time homebuyers). In addition to the bargain price appeal, these companies attract buyers with well-presented homes and special financing.

Freddie even permits homebuyers to "customize your Homesteps home." Under this option, Freddie invites buyers (for a price, of course) to upgrade their home's carpeting, padding, vinyl, appliances, and window blinds. Freddie also sells most of its owner-occupied properties for 5 percent down, no private mortgage insurance (which saves buyers $50 or $80 per month, possibly more), lower closing costs, and an attractive interest rate.

All Properties Sold "As Is." Even though Fannie and Freddie often fix up their properties, neither warrants nor guarantees the condition of a property. Unlike buying from HUD or the VA, though, as a Fannie/Freddie buyer, you may submit a purchase contract offer that includes an inspection contingency. You can purchase a home warranty plan, too, just as you (or the sellers) can with most other property sales.

Investors Invited

Both Fannie and Freddie invite offers from investors with no priority-listing period that applies only to owner-occupants. Both companies also offer favorable financing for credit-qualified investors. You pay just 15 percent down (in contrast to the conventional down payment of 20 percent to 30 percent for investor-owned properties). Closing costs may come in a little lower, too. Investor interest rates usually sit on the low side of market. You can locate Freddie and Fannie properties, and their latest loan programs, at www.homesteps.com and www.homepath.com. You can also access them through links at hud.gov.

FEDERAL GOVERNMENT AUCTIONS

Each year the federal government (in addition to HUD/VA) sells seized and surplus real estate, including houses, apartment complexes, office buildings, ranches, and vacant and developed land. Among the most active sellers are the Internal Revenue Service (IRS), Government Service Administration (GSA), and the Federal Deposit Insurance Corporation (FDIC). On occasion, you can also find properties offered by the Small Business Administration (SBA). You can locate government agency properties and sales procedures at the following web sites:

Internal Revenue Service at www.treas.gov/auctions/irs Government Services Administration at http://propertydisposal.gsa.gov/propforsale

Federal Deposit Insurance Corporation at www.fdic.gov/buying/owned/real/index
Small Business Administration at http://app1.sba.gov/pfsales/dsp

You can also find links to agency-listed properties at hud.gov.

BUY FROM FORECLOSURE SPECULATORS

A speculator wins the bid for a foreclosed property at $135,000. The property would sell for $195,000 if it were fixed up and marketed effectively. Soon after the foreclosure sale, you offer the speculator $150,000 (or whatever). To minimize risk, you attach several contingencies to your offer that permit you to get the property thoroughly inspected, evict any holdover owners or tenants, clear up title problems, seek title insurance, and arrange financing. If the property checks out satisfactorily, the sale closes, and the speculator makes a quick $15,000 (more or less). You obtain the property at a big discount without costly surprises that can turn a superficially promising foreclosure into a loss.

PROBATE AND ESTATE SALES

Probate and estate sales present another potential source of bargain-priced properties. When owners of properties die, their property may be sold to satisfy the deceased's mortgagee and other creditors. Even when the deceased leaves sufficient wealth in cash to satisfy all claims against the estate, most heirs prefer to sell the property rather than retain ownership.

Probate

To buy a property through probate, submit a bid through the estate's administrator (usually a lawyer) or executor. Then all bids are reviewed by the probate judge assigned to the case. Depending on local and state laws, the judge may then select a bid for approval or reopen the bidding. Because of legal procedures and delays, bidding on probate properties can require you to persevere. Judges wield discretion about whether to accept a probate bid. You cannot know for sure where your bid stands.

For example, a probate property came up for sale in an area of $150,000 houses. The probate administrator listed the house for sale at $115,000. A flurry of bids came in that ranged from a low of $105,000 up to a high of $118,000. Several months later the judge looked at the bids, announced the high bid at $118,000, and then solicited additional offers. Eventually, the judge approved the sale at a price of $129,850 to someone who had not even been involved in the first round of bidding. You cast your bid and take your chances.

Estate Sales

Sometimes, an estate's assets need not be dragged through the probate process. You can buy directly from the heirs or the executor of an estate. Some investors regularly read the obituary notices, contact heirs, and try to buy before the property is listed with a real estate agent. To succeed in this approach, develop an empathetic approach.

Estate sales frequently produce bargain prices because heirs eagerly want cash. They may also need the money to pay off a mortgage, other creditors, or estate taxes. Out-of-town heirs (especially) may not want to hold a vacant property for an extended period until a top-dollar buyer is found. Once again, pressures of time or money can lead to sales prices that fall below a property's market value.

PRIVATE AUCTIONS

In these times of REO stress, Freddie/Fannie, HUD/VA banks, and other owners of distressed properties are increasingly holding auctions. Attend one. Observe. You'll have fun. Often a band is playing, and food and drinks are served. A festive mood prevails. The auction company works to make potential bidders feel good. Beyond this display of cheer, though, the auction company is really setting up its prey. The auctioneer wants to sell every property at the highest possible price. Auctioneers earn a percentage of the day's take, plus, perhaps, a bonus for exceeding a certain level of sales.

To gain a bargain price, enjoy—but remain aloof from —the festive frenzy. Attend the auction armed with market and property information. Prepare to walk out a winner—not merely a buyer. Here's how you can make that happen:

- *Thoroughly inspect a property*. During the weeks before most private auctions, the auction company will schedule open houses at the properties to be sold. If you can't visit an open house, contact a real estate agent and ask for a personal showing. (Many auction companies cooperate with Realtors. If an agent brings a winning bidder to the auction, that agent earns a 1 percent or