ACE Real World
Real Estate Investment

Course #5: Helping Your Customer Recognize a Good Deal

A.C.E.
ELITE DEAL CLOSERS

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Learning Objectives

At the end of this course, the student will be able to:

1. Identify the customer's specific needs and wishes at the onset of the interaction.
2. Explain the various types of investors with regard to experience level.
3. Describe the benefits to using the MLS as an investing tool.
4. List the items that can adversely affect the market.
5. Describe how to determine the Net Operating Income of a property.
6. Explain to a customer what Cash-on-Cash means as it relates to investing in a property.
7. Explain the Cap rate to a customer and be able to calculate it for a given property.
8. Explain how leverage can help finance an investment property.
9. List reasons why financing would make sense for investment property.
10. List areas of risk when investing in real estate.
11. Describe how to manage those areas of risk.
12. Describe actions your customer should take once they are certain they are buying a specific property.
13. Explain why an 'Exit Strategy' is important in property investment.
14. List the alternatives that a 'flip investor' has if they get stuck in a property.

Timeline

Introduction	10 min.
Chapter 1: Figuring out the customer	40 min.
Chapter 2: Finding the property	20 min.
Chapter 3: Having a plan	30 min.
Chapter 4: Setting up the purchase	50 min.
Chapter 5: Maintaining and improving real estate assets	30 min.
Chapter 6: Having an exit strategy	10 min.
Closing/review	10 min.
Total	**100 min. (4 hours CE)**

Introduction

We wrote this class to get agents away from the rosy picture normally painted in investment classes. It always sounds so easy but then when you try what they suggest you lose money or even worse lose money for a customer and harm your reputation. In this class we will look at the real risks, costs, unforeseen issues, and much more. This comes from the experience of a seasoned investor to show you as agents how to anticipate and cope with the real world of investment. Making money by investing in real estate can be messy, and while we can't get you too dirty in this class we will try to get "a little mud on the tires" as we go. We want you to leave here with the real-world skills that translate into being a real-world asset to your customers.

Forward

VISION

In our extensive interaction in the real estate market both as consumers and practitioners we have had the experience of seeing both the highs and lows of service and professionalism in the real estate industry.

One common thread we have realized is that professionals' close deals and closers are professionals.

We developed our courses as a means of setting a definitive road map guiding Realtors to recognize and develop the practices that are common to professional "deal closers".

Our mission is to bring a level of professionalism into a profession that at times sorely needs it. We are the caretakers of our clients' most valuable assets and as closers, as an ACE (Accredited Closing Expert) we hold this trust sacrosanct.

That being said, we have attempted to use a little humor throughout this book to make it a little easier to read. Some may say this is unprofessional as professionals never laugh, wear a permanent scowl, and eat nothing but a diet of rusty nails. The subject matter we go into here is often dense and we wanted to take some pity on you having to read all of this. We hope a little levity will not only make it a bit of fun but also help you to remember it.

Expectations from attendees of this program:

- To endeavor to conduct every transaction in the most professional and effective manner for, most importantly, the consumer (customer) but also extending to the other professionals with whom the transaction requires you to interact.
- To continue to educate yourselves at all times on the ever-changing aspects, both legal and market related in their industry.
- To clearly keep in mind the goal of the transaction and not get bogged down in the minutia and personalities that tend to distract from that.
- To find solutions and solve problems not to doubt and aggravate issues.
- To not be afraid to say “I don’t know” once but never twice.
- To work within the realm of your expertise.

Purpose of this Course

To give you the tools to build a strong real estate business, with exceptional customer service, and advertising that is both compelling to the customer and compliant with the ethical standards we have. We will give you the tools necessary to avoid all the distractions and superfluous activities that can get in the way of closing customers for life.

Overall goals for the Real Estate Professional

Confirm that you are comfortable with losing the time required if you are going to commit the crime

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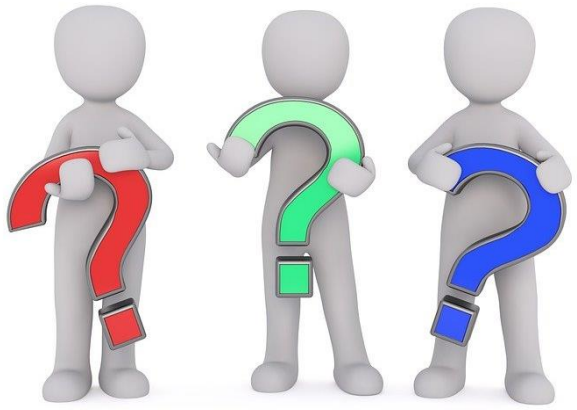
Chapter 1

Figuring out the customer:
What is their appetite for investment?



The first step to working with an investor would probably have to be your first interaction with them. Whether this is in person, on the phone, or via email what you say and don't say, what you ask and don't ask will be critical to how you are perceived by the customer. Most agents out there are happy as can be to work with an investor. The issue is they have no idea what they are doing. They think they just pick a property and try to negotiate a price and "Presto!!" money gets made. There is a lot more that goes into this and if an agent isn't aware of this and prepared to deal with the issues the agent can lose the deal, the customer, and have their reputation get hurt.

We are going to look at an interaction between an investor Alex and his agent Josh. Alex and Josh have never met and so this will represent their first meeting. Alex is an investor and would like to put some money into real estate. Josh is happy to help Alex do this. Pay attention to the interaction and see what things you can learn from it.

Please refer to the Conversations in the back on the handout

Exercise:

What did you think of the interaction with the customer?

_____

_____

What did the agent do well?

_____

_____

What questions shouldn't they have asked?

_____

_____

What questions should they have asked?

_____

_____

Did the agent find out what they needed to know to help the customer?

_____

_____

Did the agent build rapport?

_____

_____

Did the agent build credibility?

_____

_____

Did the agent build trust?

_____

_____

We don't want to be seen as just another agent. **We need to realize that most of the time a customer has a certain expectation of an agent** and that expectation is based on societies default perception of agents, what they have seen in movies and other media, and any experience they might have had working with agents in the past. This is good and it is bad. The bad news is it makes them think agents are typically not very good at what they do, they are overpaid, and easily replaceable. Sadly, many agents make the case why this thought process is accurate every single day. The really good news - the customer is coming in with exceptionally low expectations of us. It would seem we need to give a lot of thought to that initial interaction. It will be the place where we have the opportunity to show the customer we are not just like those other agents out there. We need to establish early on that this interaction is different than what they expected.

Let's dive in and take a look at that first interaction and see how it typically goes. First though let's identify what a good interaction would look like:

What two things do investors care about?

1._____

2._____

The next thing we need to do it to take the temperature of the investor. We have to figure out is if there is only one series of things we should say to an investor or if our presentation needs to vary based upon the investor we are talking to. The obvious answer is it needs to vary. There are many things that will require you to alter your presentation to the customer. The first one to consider, which will make the biggest difference in how you proceed with them will be:

1. Are they a new investor?
2. Do they have investment experience?
3. Do they have previous real estate investment experience?

I know that may appear to be the same question in three different ways but the answers to those questions will not always be the same for each investor and completely different strategies are required for each one. **The strategy we employee needs to make US the best possible asset for our customer.** To figure out which of your skills would be help the customer, we need to identify the customer type, their skill level, and adjust our presentation to give them what will be most helpful to them. Here is a chart identifying the various possible experience levels and what we need:

Investor type	Our focus needs to be	What they need
New Investor	Education	To learn and know that we know the process
Experienced not in RE Investor	A case for our product	The reasons why real estate is such a great investment
Experienced RE Investor	A case for us as an agent	Why we are not just like every agent out there

Next, we need to consider what experience they have that may in some way mitigate their risk as an investor. In other words, do they have any life experience that would make them more familiar with one type of investment property over another one. The simple answer for most investors is "yes" when it comes to residential real estate. Most people have either owned or been a tenant at some point in their life. **This experience gives them insight into how that type of investment would work**. They would have an idea of

- What owning a home is like
- What a lease looks like
- What things a landlord should be responsible for
- What things tenants should be responsible for?
- What paying rent is like
- What type of repairs are common?
- What repairs may cost
- What type of excuses tenants give
- What things a landlord can and cannot do

All of these would be things they would need to learn for a different type of property. In other words, these things wouldn't necessarily be the same if we were discussing a strip center as opposed to a residential property. So why doesn't everyone just buy residential to invest in? The answer is that many people do, and for this reason there is strong investor demand for these properties. This usually drives the prices up so that at some point only the investors that run a very "tight ship" on their properties can make a very decent return. With other investment types it would give you access to other markets that are not as inundated with investors. Many of these other types of investment can offer higher rates of return to an investor that knows how to properly run them. Once again, we are doing a risk and return analysis.

Let's look at the next interaction and see what is done differently. Here, Alex is a brand-new investor. What things should Josh do differently? How should his conversation change? What question should he and shouldn't he ask?

Exercise: New Investor Post Game

What was different from the last interaction?

_____

_____

How did the agent find out what they needed to know to help the customer?

_____

_____

How did the agent build rapport?

_____

_____

How did the agent build credibility?

_____

_____

How did the agent build trust?

_____

_____

Take aways:

What question should I start my conversation with?

_____

_____

What things do I need to know?

1._____

2._____

3. _____

4. _____

What things do I need to make sure to cover?

1._____

2._____

3. _____

4. _____

Now let's look at a different scenario: The investor this time has a lot of investment experience. The issue is that all of that experience is in other investments besides real estate. This is a different conversation than the one we just had with the new investor. This person is familiar with putting their money to work. What they are looking for is the best places to place their money to get as low a risk and high a return investment as they can get.

Exercise:

What was different from the last interaction?

_____

_____

How did the agent find out what they needed to know to help the customer?

_____

_____

How did the agent build rapport?

_____

_____

How did the agent build credibility?

_____

_____

How did the agent build trust?

_____

_____

Take aways: What things do I need to know?

1._____

2._____

3. _____

4. _____

What things do I need to make sure to cover?

1._____

2._____

3. _____

4. _____

Instead of our previous examples let's now look at a seasoned real estate investor that is coming to the table to use your services. These folks typically change agents more often than they change socks. They are not big on loyalty. We are largely interchangeable to them as very few agents really have the knowledge to stand out. Once again this is a very different conversation than we had with our last two investors. This customer knows how real estate works, and so the level of knowledge and skill you need to bring is higher and it will be challenged.

Exercise:

What was different from the last interaction?

_____

_____

How did the agent find out what they needed to know to help the customer?

_____

_____

How did the agent build rapport?

_____

_____

How did the agent build credibility?

_____

_____

How did the agent build trust?

_____

_____

Take aways: What things do I need to know?

1._____

2._____

3. _____

4. _____

What things do I need to make sure to cover?

1._____

2._____

3. _____

4. _____

Final interaction: an investor walks in and say I am looking to buy some investment property…..

Class Exercise: Prepare for the role of investor agent

Prepare the things you would want to ask an investor when they walk in:

1._____

2._____

3. _____

4. _____

Class Exercise Part ii: Role play it

When it comes to figuring out the investor there are a few things that we need to sort out with each individual as they come:

- **What matters to them?**

It is easy to just say risk and return but that does not do this issue justice. Some investors are more risk averse than others. Some find certain risks, that are normally not considered high, unacceptable while being willing to accept other higher risk things without batting an eye. People are different and investors are people. For this reason, we need to see what things they like and don't like in the market. If they are new, we need to see what things they think are risky and either build our purchase around those or show them how best to mitigate those

risks, so they feel comfortable moving forward. If they are a seasoned investor, then we need to see what things they have done and what things they feel comfortable with. There is still room for suggestions but typically this investor will be more set in their ways and less interested in guidance.

- **What experience do they have?**

We discussed this briefly before, but we want to find out what type of real estate investment they have done in the past. Each property type of real estate has unique nuances that need to be learned to maximize a properties performance. A medical office building is different than a regular office building as medical tenants have specific things they typically want that in some ways will differ from a general office building. That office building is very different form a strip store. Not just the types of businesses but also the leases, tenant improvements and many more items. If we then compare that to buying a duplex you can see that the type of experience they have can give them a leg up on a successful venture.

- **What are they looking for?**

This ties very closely to the question above, but it also applies to risk, rate of return, as well as property class, and type. The answer to these sorts of questions gives you a good idea who you are dealing with and what you need to do to make them a happy customer. Knowing the market well and having a sense for what kind of rates of returns a buyer can expect from different property types can be a huge help in showing them you are worth talking to.

- **Does it match their experience and budget?**

Sometimes people have a caviar appetite on a Mc Donald's budget. Sometimes the middle-aged career accountant wants to become an astronaut (hey both jobs start with an "A" how hard could it be). Just because someone wants something does not make it possible, and just because someone really wants to do something does not make it a good idea. Your job is to make them aware of the risks and advise them on how best to minimize them. At times that may mean suggesting they move away from the idea they came walking in the door with and instead focusing on a better fit for the resources they bring to the table.

- **What is the investor looking for from us?**

Regardless of which type of investor you are dealing with the customer wants somebody who knows their stuff. If you know what you are talking about the customer will be interested. **In reality, the customer always wants an agent that knows more than they do about real estate and the market**. They are paying a commission for a real estate market expert and that is what we need to show them to make them feel they have gotten their monies worth out of our collaboration.

- **Do you have what it takes to earn their business???**

Based upon the above description of what the customer is looking for the question you need to ask is if you have the goods to match what the customer is after? If the answer is “no”, “maybe”, or “I don’t know” then luckily, you’re in the right place. We are going to show you exceptional market insights to share with your customers to show them you are truly worthy of their business.

Chapter 2:

Finding the property: Determining if a deal has potential

This is the part where I am supposed to tell you all the cool off marketplaces to buy properties for 12.5 cents on the dollar right? Nope, we are going to start our search some place very boring: the MLS. There are good reasons to start there. The MLS has a lot of good things about it that make it an excellent starting place to begin our real world look at finding properties. What makes the MLS a great tool is:

- It represents the open retail market
- It gives us rental pricing and absorption information
- It gives us purchase pricing and absorption
- It shows us what an off-market opportunity would sell for retail
- This allows us to establish our market baseline

By looking at our absorption it gives us the ability to determine and plan for our market risk (the risk that there will not be a retail renter or buyer for our property). By analyzing the MLS data we can establish what our property should sell or rent for if we were to bring it to market today. This is what we will call our baseline. With our current market baseline established we now need to look at a couple of things to make sure we have a handle on our market.

We need to see if there are any potential forces that will affect our market. We would hope both the rents and sale prices would appreciate from today going forward but sometimes markets go down. Some things that could affect the market adversely would be.

- An increase in interest rates
- An increase in unemployment
- Recession
- Inflation concerns
- Wage stagnation
- Over building
- Changes in lending requirements

We need to gauge the market risk for these things and see just how likely they are to occur. Is there a normal chance of these things occurring or are there indicators that these things are more or less likely? We need to see what other forces could change the local market in the same way and gauge how much affect it would have on our investment. When we invest, we will be betting on the future. The one thing we know about the future is it is uncertain. We are always trying to isolate the forces that can hurt us and see how likely they are to do so. The longer our investment goes on the greater risk of adverse forces affecting our market, but also the longer a real estate investment goes on the better it tends to look.

Absorption is one of the most important things to figure out prior to investing. It will tell you what type of market you are in, and the likelihood of finding a buyer or tenant in a given market at a given price. You can see how important data like that would be for managing risk. Luckily for us our MLS make this data easy to isolate. Let's say we wanted to determine market absorption for similar single-family homes in a certain area in a certain price point. What we will do is look at the number of similar available homes in that area and simultaneously look at the closed sales in the same area for the past 6 months. We will then divide the number of closed sales by 6 to get the per month market absorption (how many homes are purchased per month) and then divide the available home by the closed sales per month to determine the current market absorption (or average time on market). Here is an example:

- Available homes currently 15
- Closed homes in the past 6 months 40

Here are our steps to solve this:

1. We divide the 40 available homes by 6: 40/6 = 6.667 (homes sell each month)
2. We divide the 15 available homes by 6.667: 15/6.667 = 2.25 (absorption rate)

This number represents how long it will take to sell all available inventory at the markets current rate of selling homes (absorption). In other words, if no new homes came on the market and people kept buying at the same pace we would be completely out of homes in this area in 2.25 months. That number also represents the average time on market. With a flip this lets us know how much time after our renovation is done we can expect for our property to need to be "carried" (we are paying the expenses for the property and any associated loans we have on it) while we wait for a buyer.

While we are on the subject of flips, let's take a look at the method used for determining value with this type of deal. We will be looking to sell to an end user (retail buyer) so the retail market will be very important for us to gauge. The method to accessing the comps in the MLS would be to look at:

- Active and closed comps for the past 6 months.
- Majority of weight given to closed sales, as these are what people actually paid not what sellers hope to get.
- Adjust comps for property differences. If our closed comps are better or worse we will need to assign values to those differences and either subtract or add those to the comp to make it match our subject property as closely as we possibly can.
- Use the adjusted values to determine the market value of your target property. With our comparable properties adjusted we will look at their adjusted sales prices and use that to determine a reasonable range or price our property can be expected to sell for in todays market.

If we switch our perspective to a buy hold customer then our focus shifts from closed sales to rented comps. As soon as buyer investor closes they will be responsible to make this property perform by either renting this property or keeping it rented**. A firm grasp on the current market rent is critical to meeting that responsibility.** The way we do that is almost identical to what we did above. We will once again look in the MLS for:

- Active and rental comps for the past 6 months.
- Majority of weight given to rented properties as the available properties have one thing in common: they have all been 100% unsuccessful at getting rented. We need to make sure our investor understands this and is looking at the rented properties.

- Adjust comps for property differences. If we are comping our parking lot view unit against a direct ocean front unit, we are not doing our investor any favors. When they can't rent their unit for the market rate you told them you will not just be embarrassed you will lose a customer and rightly so. We need to be aware of the differences and as above adjust for them.
- Use the adjusted values to determine the market rent for your target property.

With income properties (buy, hold) we use a completely different method for determining value. **The value of an income property comes from how much income it generates divided by the markets expected rate of return for that type of real estate**. This method does not rely on comparable sales to get the price but instead on comparable rates of return. An example of this would be if the market is expecting a 7% rate of return on residential income properties and our property has a net operating income of $12,500 per year then we use the following formula:

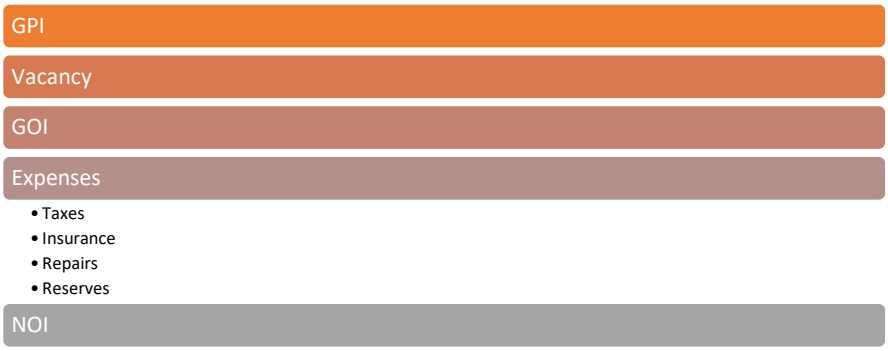
NOI divided by the market cap rate or $12,500.00/.07 = a market value of $178,000.00

Our investor could pay $178k for this property and receive a 7% rate of return from the properties net rents.

Based upon how we value income properties, what we would most like to find is a property that gives us the potential to increase its income. If we increase a properties' income, we are able to force appreciation of the property as its value is tied directly to how much income the property generates. This increase is separate and distinct from the normal market appreciation properties experience due to the market and inflation. We can also increase its value by reducing the properties expenses. If we were to self-manage the property it would show a better income due to the lowered expenses and once again increase the property's value. The other thing we can do to increase property value would be not rent related income increasers. **Things like vending machines, coin laundries, etc. all provide additional income which all add to a properties overall income generating ability and once again to its market value.**

To know what the true value of a property is though we need to clean up the numbers. We can figure out what the market rent for a property should be, which we call the gross potential income (GPI). We don't get to make all of the GPI as the property is not occupied 100% of the time. We have to remove a vacancy factor from our GPI in order to arrive at our gross operating income (GOI). We take in the gross rent, and any other income, but we don't get to keep all of that either. In fact, we have a bunch of expenses that need to get paid before we can see what we are left with in our pocket. We need to remove things like taxes, insurance, repairs, reserves, HOA fees, and any other expense the property may have. What you are left with is

your net operating income (NOI). **This is the number we need to use to do all of our comparisons for our investor.** The good news is that to get the NOI all we need to do is simple addition and subtraction. The figure below gives you a summary of the various terms and how this works.



Let's take a look at how we turn the NOI into a ROR. We will need our cap rate formula of Net operating income divided by purchase price = Rate of Return

Class Exercise:

If the property is listed for $450,000.00

4-unit property

Market rents are $1,500.00 per unit

Taxes $9,000.00

Insurance $7,200.00

Repairs $4,800.00

NOI_____

Cap Rate _____

Team Exercise:

- **Break up into groups**
- **Identify a price point**
- **Search MLS for Condo, SFR, Multi Family**
- **Determine the type of market this property is in (buyer, seller, neutral)**
- **Determine the market rents**
- **Determine Rental activity**
- **What cap rate can the investor expect?**
- **What market appreciation can the buyer expect?**

We have discussed in previous classes the major flaws in cap rate, but it is worth reiterating here to make sure that we know when to use and when not to. Cap rate is good for a quick and dirty comparison of similar types of property to each other. Cap rate does not give an investor a good idea of their overall return. It instead shows a much poorer picture of the property than is actually the case. The reason for this is that cap rate does not look at either rent increases or property appreciation. It also does not allow for a way to show the tax advantages that real estate has built into it. Let's take a quick look at this example:

- Property purchased for $200,000.00
- Held for 5 years
- NOI of $16,000.00
- Cap Rate = ___%
- Rents and appreciates @ 4% annually
- IRR = ____% Annualized
- Financed at 70% LTV at 4% 30TR Full Am
- Cash on Cash = _____%
- IRR with Debt Service _____%

Hopefully, this makes the case clearly why you need to know what type of tool you should be using and when you should think about using them. This should give you the tools you need to make an initial assessment of the market in general and try to find a property you think will be a winner.

Chapter 3:

Having a plan
Using leverage successfully for acquisitions & refinance

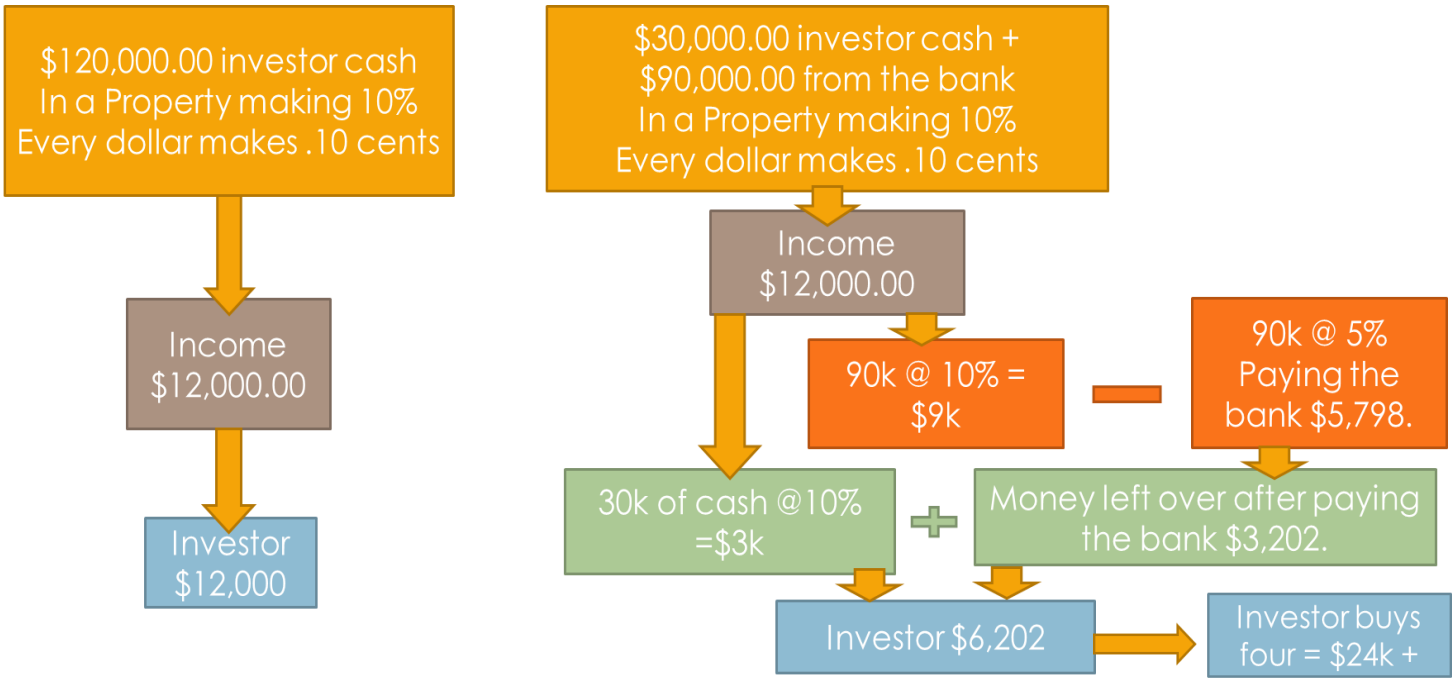
One of the most basic advantages real estate has over other investment types out there is how easy it is to finance. Not only is it easy to borrow money against real estate it also can be done at a lower interest rate than just about any other investment type out there. This gives us the opportunity to experience positive leverage. Let's take a look at this example:

Example

- Purchase the property for $120,000.00
- NOI = $12,00.00
- Cap Rate = 10%
- You borrow money
- The rate of return of the investment exceeds the interest rate on the property
- The difference between the two rate you keep
- Borrow money at 5%
- LTV 75%
- NOI after debt service = $6,202.32
- Cash on Cash return 20.7%

So why does this work? It works because while we are borrowing money to buy the property the amount we pay in interest per dollar we borrow is less than what each dollar earns in the investment. In other words, I am borrowing dollars agreeing to pay back 5 cents on each dollar I borrow but I am earning 10 cents on each dollar. That means I can pay the 5 cents

to the lender and I get to keep the other 5 cents even though I earned it on their money. Here is a visual representation of how this works:



It would be wonderful if things worked like this in the real world but unfortunately this example paints an overly rosy picture of what can be expected. Lenders tend to have additional things that get in the way of getting our mortgages done so nice clean and easy like this above example would lead you to believe. Here are some things that we can run into:
Lenders don't always lend on all properties.

- The criteria changes for certain property types
- It also changes for investors
- It also changes depending on how the property is held
- There are additional criteria the lenders have to lend us money as well.
    - DSCR
    - Reserves for replacement
- They also charge all sorts of fees that have to be added to our acquisition cost.

So in order to figure out if we will be trying to pay cash or finance our property we need to see if leverage will help our deal. Here are the tings we need to look at:

- Determine what type of financing lenders have available
- See what LTV they offer
- See what rate they will give
    - Rate often increases as LTV does
- Add any financing fees to your acquisition costs and redo cap rate
- Compare interest rate to cap rate to see if positive leverage exists

We will need to do the math to see if the cash-on-cash return helps or hurts our overall return. To do that lets quickly review the math we use to determine a cash-on-cash return:

- Purchase price + loan fees + closing costs = acquisition costs
- Determine LTV
- Determine the loan amount
    - N= Number of payments in the loan
    - I/YR= Interest Rate
    - PV= Borrowed amount
    - PMT= This will be our mortgage payment
    - FV= Any balloon amount that will be due at the end of the loan
- Determine annual mortgage fees
- Subtract from NOI
- Compare NOI after debt service to acquisition costs

That shouldn't be too unfamiliar for those of you who have taken the recommended classes prior to this one. Following the formula above will give you an after-debt service cap rate called a cash-on-cash return. In a cap rate we compare the purchase price to the NOI. With a cash on cash return we will be comparing the down payment plus any acquisition costs to the NOI minus debt service (mortgage payments). Let's put this to use with a quick exercise:

Typical Class exercise

Do a mortgage payment for this loan:

Buy for 300k @ 9 Cap

LTV 75%

What is the loan amount

$_____k

Interest rate 3.85%

Term 30yrs

Payment = $_____ annualized $_____

NOI after DS= $_____

Cash on cash = _____

Real World

Purchase price $300k @ 7Cap

LTV 70%

Loan amount?

$210k

Interest rate 5.25%

Term 30 yrs

Payment = $1159.63 annualized $13,916.00

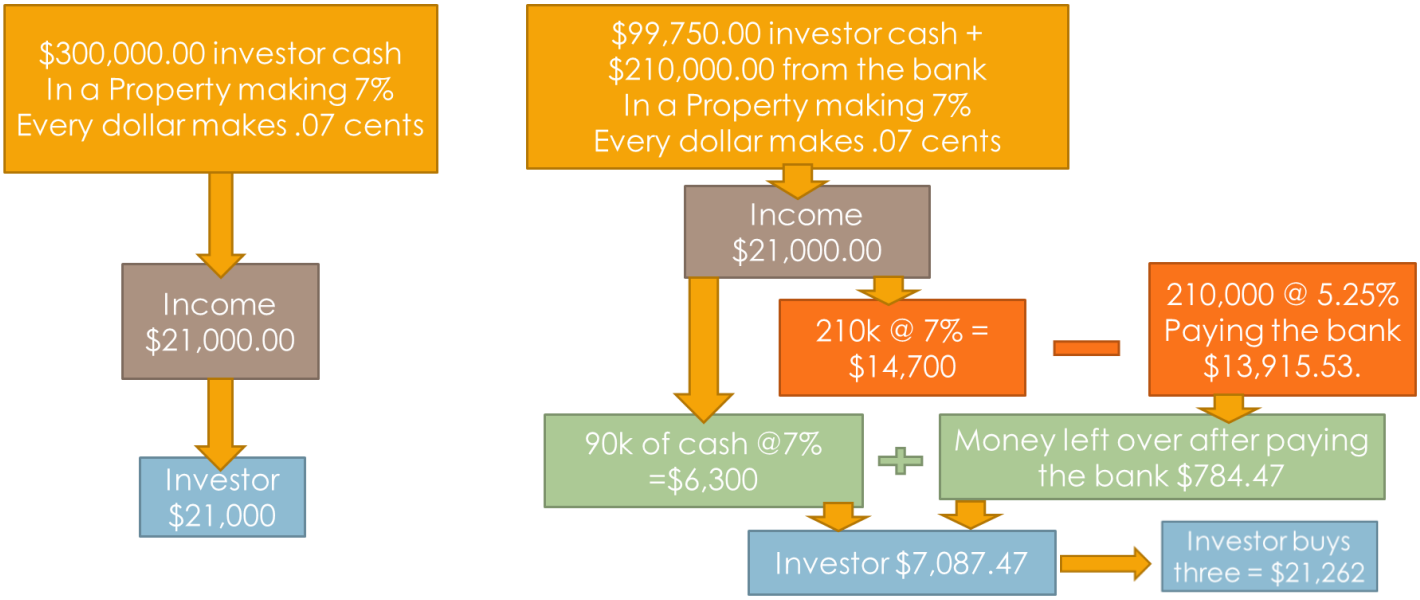
NOI after Debt service = $7,084.00

Closing costs and loan fees 3.5% =$9,750.00

Total cash at closing $99,750.00

Cash on Cash = 7%

Here is a look at this last example in the form of a diagram:



I know what you are probably thinking "real world stinks." The truth is, it kind of does, especially when compared to the examples typically found in an investment class. If borrowing money to buy real estate makes such a minor difference why should we do it? In fact, if it is so limited in its ability to help returns why do so many people borrow money to buy real estate? ***There are several really good reasons why financing makes a ton of sense.***

Reason 1 Reduced vacancy risk

With one property you will at some point be 100% vacant. This means $0 income while all expenses continue. If we look at the above example even in year one when rents would be their lowest with one property vacant the other two make enough to pay the mortgage on the third one. With two properties occupied, you do not generate enough to pay for all of the expenses but once again if we had bought cash we have $0 income so we would have no way to pay any of the expenses.

Reason 2 Multiple properties appreciating:

If you have only one property you pay cash for you get 100% of the benefit of the appreciation on that property. My $300k property appreciates 3% and I make $9k. What if I owned three properties like that with financing? I would get the appreciation benefit of $9k for each property regardless of how much money I put down to buy them.

Here is our example from the properties on the previous page:

Scenario properties appreciate at 3.5% over 5 years

- Cash purchase of one property for 300k
- **Appreciation growth of $56,305.89**
- Leveraged purchase of 3 properties for 300k each
- **Appreciation growth of $168,917.67**

*Remember appreciation is 100% tax deferred growth

Reason 3 Principal payback:

We have figured our mortgage payment out as an expense for owning our property. If we get some benefit from that mortgage payment that is not present in the cash purchase we need to include that as a benefit of the leveraged transaction. The reality is the mortgage payment includes paying back the money borrowed on the three properties we have purchased. This is actually income we are using for the purchase of paying back the loan that we are not counting as income but instead as an expense. The net result to our leveraged purchaser above is that he has paid off $49,458.22 of his loans in 5 years by making his mortgage payments. The cash purchaser does not have this benefit.

Reason 4 Multiple rents going up

This functions exactly the same way the purchase price going up did. We get the benefit for every single dollar of rent increase we see regardless of how much we put down to buy the property. In our example above it looks like this:

Scenario rents increase 4% per year over 5 years

- Cash purchase total net rents received
- **$113,742.77**
- Leveraged purchase of 3 properties
- **$132,495.36**
- Difference = **$18,752.95**

Reason 5 Tax deductible mortgage interest

This is one of those items again where we have to realize that when we compared our purchase for cash to our financed option we removed the mortgage payment as an expense. As stated previously, if there is some benefit we get from the money we are expensing that needs to be added back in as a positive to the transaction. With the cash deal we will pay tax based upon the property's income minus depreciation (which we will cover next). With a financed deal we will also get to deduct from our taxable income the money we used to pay for mortgage interest on our property. Here is what this looks like:

Scenario Investors ordinary income top rate is 28%

Total mortgage payment made over 5 years = $208,732.80

Total principal paid off = $49,458.23

Total interest paid = $159,274.57

Tax savings = $44,596.88

Reason 6 Greater basis for depreciation

Depreciation is a loss that we get to take on our taxes to reduce how much taxable income we show to IRS. This loss is limited to the improvements on the property. The IRS knows dirt doesn't go down in value, but they do allow for the loss of the building wearing down. In the case of our transaction above it looks like this:

Scenario: Property is residential 80% allocation for depreciation and held for 5 years

Cash Purchase

Total depreciation = $43,636.36

Tax reduction @ 28% tax rate= $12,218.18

Leveraged purchase

Total depreciation = $130,909.09

Tax reduction @ 28% tax rate= $36,654.55

Could we calculate the benefit of all of these things for our investor to make the case for why the financing option is the better way to go. Because we do not have the investor's ordinary income rate let's just focus on the difference in the internal rates of return from the cash deal to the finance deal over 5 years figuring on the appreciation listed above:

- Cash
- Yr 0 = -$300,000
- Yr 1 = $21,000
- Yr 2 = $21,840
- Yr 3 = $22,713.60
- Yr 4 = $23,622.14
- Yr 5 total = $368,824.61
  - Yr 5 rent = $24,567.71
  - Yr 5 sale price = $344,256.90
- **IRR= 9.95%**

- Financed
- Yr 0 = -$300,000
- Yr 1 = $21,252
- Yr 2 = $24,558
- Yr 3 = $27,210.48
- Yr 4 = $29,968.83
- Yr 5 total = $485,066.42
  - Yr 5 rent = $32,837.49
  - Yr 5 sale price = $452,228.93
- **IRR= 16.13%**

That is a real-world look at the benefits of financing but there are still some things we need to add in to make this really as accurate as we could. There are expenses and risks we need to consider:

- We should have added a vacancy factor
  - It would have been higher percentage for the single property than for the three
- We would need to deduct commissions if we use an agent to rent the property.
- We would need to deduct management if we had a management company

With that said we have looked at the things we need in order to determine how good or bad a property we found is. Now we need to look at what risks the investor faces when buying a property and figure out how to best manage those things.

Chapter 4:

Setting up the purchase
Managing risk successfully for acquisitions

Risk is one of the big deal items we talked about for investors as it makes up half of the big two things our investors care about. We are going to need to look at all of the common risks that can come up and either figure out how to disregard, mitigate, or accept them. Some of these risks have very simple solutions, but those solutions cost money and investors often debate whether to save the money and accept the risk or to pay for the risk to be mitigated. That conversation is one you as an agent should be a part of. **You need to know and be able to explain the risks and the potential exposure for the customer so that they can make the best decision as to their method of handling risk in the transaction**. Let's jump right into the risks we will need to look at prior to purchasing our property.

Latent defects

Latent defects refer to things that are not readily apparent or cannot easily be seen. This is the risk of things hidden in the walls, attic, underground or other really interesting places. One way we try to mitigate this type of risk is with a home inspection. The home inspector's job is to find latent defects, but those that are visible by a limited visual inspection. In other words, they

will catch some stuff but not all stuff. Often investors will buy properties without a home inspection to save money. They do so, trusting in their own ability to spot issues, or a feeling that the purchase price is good enough that they will be able to fix anything they find. **We need to have the discussion with our investor customer to let them know of this risk and decide how much risk our they comfortable accepting in the latent defect department.**

- **Deferred maintenance**

This is the ultimate in latent defects so it could be lumped in with the above category but is significant enough that it got its own. This is the risk that the systems of the house have not been properly maintained and therefore the expected usable life will be significantly shortened due to this fact. An example of this would be an a/c that was run for years without a filter but prior to listing the property had the coils thoroughly cleaned. The a/c looks in good condition but in reality, it has been overworked for years and will not last as long as the units age would normally dictate. Having a fold of pro's that will come check a house out for you can be a huge help to avoid things like this. Home inspectors can be a help but getting in the actual sub-contractors you intend to use during your inspection period for an estimate is always a way to try to minimize these sorts of things.

- **WDO & other pest risks**

Termites and other WDO's (wood destroying organisms) are always a risk with any property. Once again, we can pay for a WDO inspection and help mitigate this risk. The thing is many times homes may not have active termites but instead have had termites in their past. Most homes have termites at some point in their history. How quickly those termites are recognized and dealt with will largely determine how much damage they actually cause. This is another latent defect type of issue. The home can look good to all sorts of inspections and yet still have extreme damage inside the walls. **Having an inspector that knows what to look for to identify this or knowing what to look for as an investor is the best way to mitigate this risk.** Getting a copy of any kind of a termite policy is always a good way to minimize your exposure on this.

- **Title**

This is one that seems to have an obvious solution. Just get title insurance, right? You have to get title insurance when you buy anyway right? Well, as it turns out title insurance is not required when you buy a property with cash. A bank will require you to have title insurance in order to give you a loan as they want to be sure of the title on the property you are pledging as equity. In a cash deal it is up to the buyer if they want to pay for title insurance or not. An

investor is always watching every nickel and so this one item you need to have an answer for. **The risk of not having clear title to a property is not high, but the consequences of it are very large**. You could wind up in a protracted legal battle and even lose the property potentially. One way to avoid the cost of this is to have the seller pick the title company and pay for the title insurance. On the surface this can be a cost saving answer, but caution must be used when acquiring foreclosure properties from banks with this method. Many times, the foreclosing bank uses an affiliated title company. This title company will write the title policy over things that other title companies would not. When it comes time for your seller to attempt to resell marketable title can not be issued by the new title company. To avoid this risk a title policy should always be acquired on any property purchased. Have the buyers' attorney review the title if the seller is providing the title policy. Make sure the buyers' attorney is familiar with title before accepting their sign off on it. If not, take it to "your person" at your title company to get their blessing before agreeing.

- **Encroachments**

The way to deal with the risk of encroachments is the survey. This is much like title insurance in that if you borrow money to buy a property the lender is going to require you to get a survey but if you are buying cash, you have the option to pay for one or not. As with the other things here, our investor may ask our opinion and we need to be able to advise them of their risks. Most encroachment issues can be solved with enough time, work, and sometimes money. The issue is if one of your buildings is partially on someone else property and we find out prior to closing we can cancel or renegotiate with the seller. It is the seller issue to fix and we are in the driver's seat. If we find out about this issue after closing, then it is our problem, and we will need to go to the neighbor with no leverage possibly with "our hat in our hand" asking for help. This is not a situation any investor wants to find themselves in. So always recommend a survey.

- **Violations/liens**

Liens are discovered on the lien search done normally during the closing process. This implies that the property is purchased on a standard contract that calls for the seller to deliver the property free of all liens. As you work with investors more you will see that not all deals are done with contracts that require the seller to close all liens. Many times, a simple quit claim deed is all that is executed to transfer title and a buyer accepts the property with all of its baggage. Typically, the buyer will do this because they are getting a good price and they feel it makes the risk worthwhile. In a city lien/violation situation you want to meet with the city in advance and try to get a feel for their settlement criteria and what the reduction would be that they would be willing to give.

If it is another type of lien, you will need to determine what the lien is and how reachable the lien holder will be. Sometimes, lien holders go out of business or other fun stuff that makes closing these out challenging. The big issue is when working with investment properties is that they often have a bit of a messy past on the title side. Title companies tend to be ultra conservative when it comes to underwriting old title issues even when the law says they are not a cloud on title any longer. This makes investors frustrated and question the efficacy of title insurance. **When working with an investor it is usually best to use an attorney to do the title work as they tend to be more willing to overlook items that are no longer an issue.**

- **Open Permits/Work done without permits**

Work done without permits is sometimes obvious and sometimes it is not. It can become an issue if you seek to do work requiring permits only to find out that part of the existing structure or systems should not be there. This can be very costly and take a deal from profitable to unprofitable very quickly. When at all possible, you want to review what the city has for size and bedroom/ bathrooms of the property and make sure it matches (at least fairly closely) with the actual home. If these don't match then you will need to find out if permits were pulled, and if not, you can still buy the property, but you need to make the investor aware of this exposure. This may limit the number of buyers willing to purchase this property and it may limit what things you can do (or at least permit) to renovate it.

- **Time/Delays**

Not much will eat your lunch faster than time delays on a project. **If you are flipping a property minimizing your carry costs (the cost of owning the property) is key to profitability**. As a flipper I need to be "turning my money" several times a year. If I am not, I will not make the kind of income I need to do to have it make financial sense. If you are an investor that is buying to hold, you have the exact same issues except that instead of selling you are trying to get the property producing income with a tenant. Minimizing delays in real estate is one of the hardest things to do. **Having a good project timeline is a key part of this**. Another important item is to have someone whose job it is to be responsible for maintaining the timeline. The other important thing you should try to do is get as much preplanning done as you can prior to closing so that you can try to get ahead of your project timeline before you even own the property.

▶ Cost over runs to repair

Another killer like time overruns is going over budget. There is no way to tell what you will run into once you start renovating a project. Change orders (what contractors call changes to the scope of work) occur often even with the best intentions of all parties involved. Even when you are doing the work yourself you will run into things all the time that make you spend more than you thought you were going to need to. **Having good, experienced people do your estimating can help, as can making sure to leave room in your budget for unforeseen issues.** You always want to make sure that when you are getting estimates from your contractors you actually listen and don't just look for the lowest price. Many contractors will bid to give a lower price to get the job only to hit the customer with a pricy change order the contractor knew they would need at the beginning. Many times other bids will contain these items but because the bids were more expensive the investor went with the cheapest one. Be sure with estimates you are comparing apples to apples.

▶ Bad contractors

In keeping with the cost overrun's theme, you have to spend some time on the risk of bad contractors. This is a huge one that kills a lot of new investors. As mentioned above you will get folks that will bid low leaving out work, they know you will need only to come back and make you pay for it heavy with a change order. It is important to develop great contractors to recommend to your investor customers. As an investor you need to take time developing these relationships as these are the lifeblood of your ability to make projects profitable. Quality work is super important to avoid home inspection issues or tenant complaints. If you think you have a bad contractor, get rid of them quickly. Try to find a contractor that buys into what you are doing and wants the consistent work that an investor client can bring.

▶ Utility reestablishment

Turn the lights on? That's easy just call the power company right? Not so fast Jack! The utility companies may require you to get an inspection from the city or a licensed tradesperson to get the power turned back on. This can create issues if there is work that was planned to be done later on that now must be done to have the utilities reestablished and then will need to be removed and redone later. It can also be a huge time delay issue. We have had projects where it took over a month for the provider to reestablish electrical power after the inspection by the contractor was complete and submitted to them. **Prior to closing make sure to reach out to the utility companies about an issue there might be for establishing service to the investor's property.**

▶ **Usable life on components**

This can get you a couple of different ways. The big one is when you have delays in your project and items that still had some usable life left now are near or at the end of their usable life. The other issue is not budgeting for limited lifespan on appliances when you buy a property to hold. Typically, if you are maintaining the existing appliances in an investment property they are not new. This means they are somewhere in their lifecycle that needs to be calculated and budgeted for. **Your investor will need reserves or some kind of a maintenance contract/home warranty to help mitigate this risk.** When doing the assessment of the property you want to estimate the usable life that the appliances have left. Here is a little chart to help:

Major Home Appliance Life Expectancy

Life Expectancy (Years)	Low	High	Average
Trash Compactors	7	12	11
Dryers, Electric	11	18	14
Dryers, Gas	11	16	13
Dishwashers	9	16	12
Garbage Disposals	10	15	13
Freezers	12	20	16
Microwaves	5	10	8
Ranges, Electric	13	20	16
Ranges, Gas	15	23	19
Ranges, Hoods	9	19	14
Refrigerators, Compact	4	12	8
Refrigerators, Standard	10	18	14
Washing Machines	8	16	12

Determining how much time you have left for these items to not wear out will help with budgeting for replacement and also for setting up monthly reserves.

▶ **Existing Tenants/residents**

Sometimes you get a property you want with a tenant or resident you don't want. We have already seen how delays cost money. Now we need to recognize that getting people out can be hard or easy depending upon many factors. **You will need to review your landlord tenant law to know what you can do with getting a tenant out**. Even if the property is a foreclosure there are usually laws that spell out how much time you need to give a tenant to move prior to removing them. Also, if it is the previous owner of a property you took back

through the foreclosure process still lives in the property, there will be a very specific set of steps you will need to remove them. They can always fight the process as well. This can create huge, unexpected delays. So, while a writ of possession may be the legal remedy, it may make sense to offer cash for keys with some residence. This is an additional cost that should be budgeted and needs to be weighed against the cost of losing time and legal expenses from a difficult to displace resident.

▶ Vacancy

There are many things that can happen to a vacant property and with no one in the property to let someone know the damage can be devastating. We covered the risk of vacancy from the perspective of not being able to find a tenant in the previous chapter. Here we are discussing what happens if a pipe bursts in a vacant home and no one finds out for a week. When a property is being set up for renovation there are often times when no one will be scheduled to be there for several days or even weeks in a row. Without a person there to let you know when something goes wrong and to try to minimize damage you could wind up with a property that is utterly destroyed. To minimize this risk someone needs to be responsible for routine inspections or some sort of surveillance should be used. When something goes wrong we need to minimize its ability to adversely affect the property.

▶ Association requirements

When buying a home in an association you have an additional authority to go to in order to get permission to use your property as you see fit. This was agreed to when you saw the condo/HOA docs and did not cancel the deal. The issue is the rules for these associations can be costly or arduous to follow. They will dictate when a property can be worked on, what type of elevator access you can have, protection of floors, and much more. The association also has the ability to change their rules. This can be a real concern if a rule change will inhibit your ability to earn money with your unit. The best way to minimize this risk is to go to a building meeting before buying. Or if you can meet with the manager and board members and see how they feel about things. Getting a feel for the folks making the rules can only help you going forward.

- **Special assessments**

This is the risk that poor management in the past or unforeseen circumstances come back to bite you in the wallet. Special assessments are usually a direct reflection of an associations inability to save in the past or a penchant to keep their HOA fees too low and thus not have the money to maintain the property. Either way you do not have a recourse if they drop one of these suckers on you after you close. You may have to either write a big check or make payments for a potentially long period of time which all come directly out of profits. To mitigate this, see above. Try to meet with the manager or board members and see what potential projects may be coming your way.

- **Neighborhood**

The neighborhood seemed nice. The problem is you only saw the property during the day and didn't realize that commercial building on the corner was a nudie bar, or maybe those really nice folks that are always poking their heads into people cars to say hello. You would think they would be cold in those fish net stockings, but I guess their natural friendliness keeps them warm. Speaking of friendly that guy on the end of the block that has those poor folks constantly coming over with the desperate look in their eyes only to disappear for a while and emerge so much less stressed. Lots of things can make a neighborhood a problem. It is impossible to know every single area in most places. **That being said, you want to drive by a property you are preparing to buy at different times to make sure to try to avoid this type of risk.**

- **Vandalism/squatters**

This falls under another vacant property risk, but because it is such a big one it gets its own section. There are people that look for vacant properties to break into and live in while they are empty. These folks usually are not the tidiest folks on the planet. In fact, as it turns out they usually leave a home filthy with all sorts of "paraphernalia" to demonstrate all that they were up to in your investor's property. These folks are predators of opportunity. **The way to avoid them is to first secure the property well**. An alarm system is never a bad idea, and frequent property inspections will let squatters know to stay away. An alarm system with cameras is one of the best ways to deter vandals and to targets of lesser difficulty as well.

- **Liability/Uninsured loss**

Investors are often hesitant to spend money on things and this makes them often willing to take on risks to avoid the expense of mitigating them. One place they sometimes want to skimp is in paying for insurance for the property. For a financed buyer, the lender is going to require

this but for our cash buyer it is an option. The issue is that if something does happen the investor will be responsible for the loss in its entirety. This means if the property were to burn down the owner would have to rebuild if they could out of their own pocket. The owner can mitigate that with insurance. With liability there are some other things we can look at. If the owner wants to be self-insured for liability they will want to limit the number and value of the assets that a person suing them can have access to**. The first thing they will need to do is hold the property in a corporation.** This will protect the investors personal assets from lawsuit. The next thing to do is make sure that no one corporation has more assets in it than the investor would be willing to lose in a lawsuit.

- **Time on market to sell**

Just because the market is hot now does not mean it will be when it is time to sell this home. What if when we list for our expected price, we do not get a buyer right away? Just because we have a projected sale price that we think is good, does not mean that we will get a buyer right away. If we don't, we are back to having carry costs that eat directly into our profits again. Having a willingness and a budgetary ability to accept an offer below full price is an important part of being ready to get a deal done while one exists. **We need to know what number we want and what number we can take to make sure we are ready to keep our property from lingering to long on the market.**

- **Market Risk**

Markets change. We can project but there is no way to know what type of market we will be having to sell into. **To mitigate this risk, we want to keep our renovation timelines on our flips as short as possible.** We do this so that there is less time for a major market changing event to occur. If we are holding the property for cash flow purposes, we want to have an alternate exit or at least a means of helping ourselves out if the property doesn't sell on market. An ability to refinance to liberate some money and keep the property to wait for better market condition would be an option.

- **Refinancing risk**

Many loans offered to investors have balloon payments on them. These loans basically force the investor to refinance their loan in order to pay off the loan balance when they become due. A typical investor loan might have a payment based on 30-year amortization but require full repayment in 5 years. What happens if the lending market is not conducive to the investor getting enough to refinance the property? If interest rates are much higher the investor may have a huge increase in loan payment to pay for the same amount of money. For

this reason, **it is best to take loans with at least some amortization**. This means some of the principal has been paid back and loan that will be needed will be a slightly smaller loan than the initial one was.

- **Liquidity**

Real estate is not a liquid asset. This means that you can't just get cash for your property today. It takes time to sell a property and a buyer must be found first. To get full market value that search will take some time. For this too is important to advise investors to always have cash reserves. If not it is very possible to wind up in a situation with millions in assets but an inability to afford a hamburger at Mc Donald's. Most real estate investors have experienced this real estate rich cash poor phenomenon in their lives before. It is not fun. Make sure to keep a little cash back to keep yourself from a position of desperation.

- **Analysis paralysis**

This is the risk that while you were worried about all these other risks someone else bought the property out from under neath you and now you are not investing. The risk of not investing can't be overstated. Money only works if you make it. If your money is not working then you are the only one supporting you. That means if anything happens to you then you are in deep doo-doo. The best way to mitigate this risk is to keep in mind there are no perfect deals. Real estate always looks better with time. If you can find a way to hold on even not so great deals look pretty awesome in hindsight.

We have now looked at our main risks and tried to address them. The next thing we need to do, after considering our risk assessment, is to look at how we are buying the property and some research we need to finalize our budgeting. We have some tough decisions to make and they start with:

Buying cash or financing?

This is a decision we will need to make based on several variables. Do we have the cash to purchase? Can the property be purchased with financing? How much more expensive will it be to buy with financing? What kind of interest rate will we have? If we pay cash, will we have the money for the rest of the things needed to be done to bring the property to market? If we pay cash, can we refinance after the fact to liberate capital? Does financing improve our overall return significantly? Once we answer these questions, we can decide what is best for our transaction. If the answer is to pursue financing, then we have to ask:

Conventional or hard money?

If we decide to borrow money, we need to know what our source will be. Conventional loans typically have much better interest rates and loan to value ratios than hard money but also require more time and documentation to complete. Often sellers of investment properties do not like deals contingent on financing as the seller has a greater risk of the buyer not closing due to a financing issue and still receiving their entire deposit back. For this reason, sellers are going to want a higher purchase price to incentivize them to take on that additional risk. This will affect our rate of return for the asset adversely. If we borrow hard money typically we can treat this loan as almost cash. We can usually close one of these loans as fast as the title search comes back. We will not get as much money and will pay a higher interest rate but should still be able to get a cash price for our purchase. Either way some of these loans are set up to help rehabbers. We need to now know:

Will the loan have draws for renovations?

Renovation loans are not a new thing, and there are plenty of lenders out there that will give you a conventional or hard money loan that includes a draw schedule for construction work. The thought being that as more work is done on the property it becomes more valuable and thus able to support more financing. In order to get this kind of loan though normally you will need an estimate and even a signed contract from a licensed contractor. We need to make sure to have the contractor lined up for this with a draw schedule they will be willing to work with.

Have we done the research on the level of finishes needed?

We should have identified a target buyer/tenant and price point for our property prior to purchasing it. We need to make sure that we have considered and calculated in the cost of the finishes we will need for the property to sell or rent in the market to our target customer. If our finishes are not good enough, we may not attract the targeted price or time on market. Going back to redo something you already paid for once is doubly painful so make sure to give this the time it needs and get it right.

What type of budget do we have for repairs?

We need to look at our contractor estimates and confirm they match our projected budget. If they do not, we need to redo our budget with the contractors' numbers to see if the property still works or not at the new numbers. If not we may need to find a new contractor, renegotiate the price of the property, negotiate with the contractor, or walk away from the deal.

What is our time frame to get the property performing or sold?

This is one more time where we need to compare our projections to what our contractor is giving us. Prior to moving forward, we want to allow for delays for inspections, drawings, and missing materials. How long have we given ourselves, and is it enough time? Do we have a plan when the project runs long?

What needs to be done to fully secure the property?

Once we close the property becomes our responsibility. This means if anyone breaks in or anything is damaged the cost to repair those things will be coming out of the profit of this investment. We need to know:

What things need to be done to secure the property once we close on it?
Will any materials be needed?
What is the lead time to get those materials on site?
When must they be ordered to be present at time of closing?

We need to make sure to have everything we need to secure the property with enough time in advance that if anything is missing, we have an opportunity to make alternate arrangements. This is a little thing but can be very costly if not properly handled.

Go close!

We have now fully considered our contingencies unless there was something special about the property. All that remains to be done now is to go close. Make sure the investors attorney reviews everything and signs off. We now have an investment property!!! Now what?

Chapter 5:

Maintaining and improving real estate assets

There are a lot of things that go into getting a property ready for market. Below we are going to cover the most pressing of these things to give you some idea what to expect. The first thing we need to do is to enact our plan for securing the property:

- **Securing the property**

We need to make sure the property is secured from trespassers or squatters. We also want to make sure the people that will need access can get it. Using a lockbox on the front door gives people access but it also potentially alerts people to the vacant status of the property. Placing the lockbox in a less obvious place is usually a better bet. Also confirm all windows are locked and secured with movement restricting devices. This can be a simple as a stick. The reason for this is, it is easy to force a window open if you know how to. If properly secured this should prevent that. If the neighborhood is bad enough you may instead opt to board up the windows. This should be done in such a way that the damage from the boarding up can be easily repaired when they are removed.

- **Get any required drawings**

This is one thing that your investor probably should try to have in motion as soon as they are certain they will be buying the property. **You want to at least have the engineer or architect out to the property to get their measurements and get started**. In order to pull permits for work, drawings will be needed, and they often take a significant amount of time to get back from the person doing the drawings. This delays your project and has you paying carry costs while these delays are happening. We want to minimize this by getting any drawings started as soon as possible.

- **Complete project budget**

Once we have our drawings in hand we can get confirmation from the contractor that the estimate provided is still correct based upon what is called for in the plans. This is important to do as the drawing may call for things that the contractor could not have foreseen needing prior to receiving them.

- **Complete project schedule**

If the drawings changed our scope of work by adding things that were not part of our contractors estimate those changes have probably also added time to the schedule to complete the project. **This means we need to check and complete our project schedule at this point in order for it to be accurate**.

- **Pull any needed permits**

This is another time sucker than can eat your profits up alive. When you submit plans to the city they will review them (when they feel like it) and give you comments for revision. These comments you give to the person who did the drawing, and they make the corrections (when they feel like it). They then resubmit the corrected drawing to the city which they review (when they feel like it) and if they do not have any more comments (which they often do) they issue the permit for the job. **Pulling permits requires someone to actively interact with the city**. If you don't the city will take their sweet time getting anything done. Also, you want to make sure to keep the bull whip ready to go for whoever is doing your drawings as both of these folks can kill you on this.

- **Decide on project management**

Managing a construction project is no joke. It is a busy job and depending on the scope of what you are doing it can be a full-time job. **Your investor will either need to hire a general contractor to do this for them or they will need to do it themselves**. If the investor does not have the construction background to do this themselves they should definitely get a

professional to handle it for them. If they want to learn to do it they should hire the professional and let them know they want to be taught how to manage a project along the way. Many contractors would be happy to show you the ropes if you ask and are not a huge pain in the butt.

- **Engage the contractor(s)**

It is now time to hire either the subcontractors, if you will be managing the project yourself, or the general contractor if they will be the one doing the managing. **Make sure that standards and communication are discussed.** You want to make sure the investor knows who will be doing the work and who they need to contact with any issues.

- **Engage utilities**

If you want the project to get done most quickly having the utilities turned on at the property is a huge help. As we discussed earlier it is not as easy as a phone call sometimes to get things turned on. You want to be working on this as soon as you close to make sure you have water and power for the construction crews to work most effectively. You also want to have the power on to prevent the development of mold which we will discuss later.

- **Engage landscaping services**

One thing that can be easy to overlook but can become a huge pain in the neck is the lawn. Cities will fine you and eventually send their own (very expensive) crew out to cut the lawn if it is not properly maintained. **The best way to avoid this is to immediately start the lawn service for the property as soon as you close**. If the property is an eyesore on the block and you are the one cleaning it up you will probably get the good will of the neighbors. If the property is uglier since you took it over, do not be surprised when the city gets called out by an anonymous concerned individual.

- **Take mold prevention steps**

The biggest and easiest step you can take to prevent mold would be to get the a/c working properly in the property. The a/c is the chief dehumidifier in the house. By cooling the air it removes excess moisture which the mold thrives upon. Other mold preventative measures would be to seal any areas that show any signs of moisture intrusion. This can mean tarping a roof or using caulk around windows or to fill in cracks. It doesn't need to be pretty initially it is just to keep there from being degeneration in the asset that was purchased. You will be doing things later to seal the house and make it pretty like our next step.

- **Paint**

Believe it or not paint is the primary vapor barrier for many forms of construction. The latex paint we use forms a glove like cover around the property to keep water from entering it. For this reason, it is very important to maintain the paint on any property to keep moisture from entering the home and causing damage and potentially mold.

- **Plumbing retrofits**

One of the most common retrofits required in homes would be for plumbing. Cast iron pipes were used for decades to carry wastewater underground. These pipes have a usable life that normally seems to be running out just around the time you are closing. The big issue is these pipes are run under the slab of the house requiring extensive cutting and pouring of new concrete. The other thing that often causes plumbing retrofits is polybutylene piping. This is a piping that with time can burst and cause water damage. Most insurers will not cover homes that have this type of pipe in them , and if it is something that you discover the home has, you as the seller must disclose it to the buyer. **That being said you will probably want to replace it as it is a huge turn off to buyers and a huge risk if you are a landlord.**

- **Electrical retrofits**

This is something that you may not be expecting and should. **The law has changed and requires any electrical circuits that will be affected by the scope of work to be updated to current code and be protected by arc fault circuit breakers.** This means if you are replacing the cabinets in your kitchen, you will most likely be looking at a major electrical bill. Because they do not make the “skinny” version of arc fault circuit breakers many electrical panels do not have the room for them. This means a new panel will be needed. Also, the number of circuits required in a kitchen has increased which means new wire will need to be run. If your panel doesn’t have room for the needed circuit breakers (as is often the case in condo units), you will need a new panel. If the wires are not long enough from the electrical distribution area, you will need to run new main feeder lines. For these reasons if you are doing work requiring permits be aware that the electricians bill can be pretty hefty.

- **Visit the site**

The site needs to be visited and it needs to happen regularly to make sure work is being done properly and nothing is allowed to get too far out of whack before someone spots it and stops it. This needs to be someone’s responsibility to do. If not the project can run off the rails and no one will know about it until it requires a costly repair to get it back on track. Inspections are especially necessary if the property will be sitting vacant for a while during job lulls. It is

possible for materials kept on site to be stolen and usually construction contract makes theft of materials stored on site the responsibility of the homeowner.

- **Implementing the "plan"**

We worked on a plan to establish what finishes we would need to attract our target tenant. Now it is time to put that plan into action. Make sure the materials you want to use will work properly together. If you are keeping a property to rent, you want to make sure the materials will be durable through tenant wear and tear. Make sure the finishes look good prior to installation. Often things will look better online or in a catalogue than they do in person. Make sure the best parts of the property are highlighted and the weakest parts of the property are minimized in your implementation of your plan.

Some items especially for income properties

- **Value added items.**

We know that with rental properties their value comes form the net income they generate. This extends to any alternate income streams a property can provide. Things like vending machines, coin operated laundry, or (in some markets) renting out parking spaces can all increase both your income and your properties value. Making sure you have what you need in order to facilitate these alternate income streams needs to happen during the renovation portion of the project. It is great to plan to put in a coin operated laundry but if the renovation is complete and no one remembered to run the water, waste, and electrical lines you have what in certain circles is referred to as "a problem."

- **Decide on property management**

During the renovation process you want to be interviewing property managers if you do not have one you have used previously and have decided not to self-manage. Getting the property manager involved sooner rather than later is not a bad thing. They can be aware of the improvements you have made and will know what things are new and what items may need repair relatively soon. Letting the manager know when you plan to bring your property to the market can only help them be prepared and possibly even work on getting it rented prior to completion.

- **Leases**

If your investor is going to rent their property out, they are going to need a lease. There are many standard leases that exist out there in the world but that does not make them all equal. Many states have a lease for real estate agents to use. The question still remains though what lease should an investor use? The best results come from a lease created by an eviction

attorney that will represent the lease if there is an eviction that is required. You want a lease that favors the landlord as much as possible to avoid as many issues as possible with problem tenants.

- **Tenant screening**

The investor needs to know who will be occupying the property in which they just invested so much time and money. The screening process needs to be discussed and decided on. Will the owner do their own screening? Or will they require the tenant to do their own and provide it? Will the property manager handle it? Will the tenant be responsible to pay for the landlord's tenant screening? What if the property is in a community that makes the tenant pay for a credit and background check to provide to the board, does the tenant then need to pay for two? Or will you accept the board's decision to allow he tenant in? There are a lot of moving pieces with tenant screening and that is without getting into the need for standardized approval guidelines to avoid discrimination issues. This is one of the main reasons to have a property manager for your property. They get to handle all of this aggravation and you just collect checks.

Back to stuff that affects everybody.

- **WDOs and other fun**

Sometimes after you buy a property a friendly family of rats decides to take up residence in the property. This is something that can be very costly to deal with as rats will eat just about ANYTHING. They can chew up your HVAC lines, create leaks, and all sorts of other fun stuff that I won't mention here. That is just one type of pest. Termites can also come and eat you out of house and home. We discussed those previously from the standpoint of not buying a home with them, but now we are talking about when you bought the house and then the house gets them. **This is why visiting the property is so important.** As soon as someone sees any evidence of any type of pest action needs to be taken immediately to eliminate them. The damage they cause increases exponentially the longer they are allowed to survive.

- **Marketing the property**

The property will need to be sold or rented. Will the investor be doing this themselves or with an agent? Who will be that agent? Does the property management company reserve the right to market the property? What type of commissions will they charge? Time needs to be given to make sure the strategy we have to market the property will match the type of customer we were finishing the property to appeal to. **An agent needs to be able to know how to use the comps to help get this seller top dollar for the property.** They need to be able to explain all the work that was done and even provide receipts (for completed work to back up the investment the investor has) to get appraisers to give maximum valuation. On the rental

side the agent needs to know what was done to the property and position it in a way that potential tenants recognize the value the landlord is offering them with the property they are making available to them.

- **Refinance**

One of the best strategies with income properties is to buy for cash or with hard money, stabilize the property, (renovate it and get it rented out, and fully performing) and then refinance the property at its new higher value. This will liberate much and sometimes even all the money the investor has in the property which allows them to reinvest. If they had a hard money loan the refinanced loan will usually be a much lower interest rate. These loans are often fully amortized and over a long period of time 20-30 years.

One more thing to keep in mind with refinancing is that it is a way for investors to recognize the property's appreciation without selling the property. In other words, if the investor held a property for five years and then needed money, yes, they could sell the property and recognize their appreciation, while also creating a taxable event or they could refinance the property that has appreciated and take additional loan proceeds if the equity exists for that. There are many advantages to the refinance not the least of which is you still own the property. This is a great option to keep in mind to suggest to your investor customers if they ever find themselves in a cash crunch.

Class Exercise

Refinance our property out of the money loan based upon current market value.

Hard Money Loan terms 60% LTV interest only 12% Interest Rate

New Loan Terms 70% LTV 30 year am 5.25% interest rate

What is our updated rate of return? _____

Chapter 6:

Having an exit strategy: Knowing how and when to get out

In most things in life it is important to have a sense of timing. This lesson is driven home early on in life when playing that famous kindergarten blood sport known as musical chairs. If you don't time it right, you are left without a place to sit when the music stops especially after the cute little girl in the pink frilly dress turned out to have a better right hook than you thought she would when you tried to go for the seat she had her eye on. Later on in life you never want to be the last person at the party that the hosts are eyeing wondering when you will leave. Knowing when to stay and when to go is an important part of many situations and investment is one of those things.

If we want to know when to get out with investment the first step would be to make sure that we can get out when we want to. This means we need to take some time to consider who our buyer will be in the future. The answer to that question will differ depending on the type of investment we are doing. A flip is banking on a buyer as soon as possible whereas an income property investor may be project 5, 10, 20 or more years out. The issue comes if we can't get out the way we thought we would be able to. Do we have an alternate exit in mind?

So, let's look at a summary of what the flip investor exit strategy is and some alternatives if they get stuck:

- With flips we built for where the market is
- Our exit is a resale after renovations are complete
- If we have cost overruns, we may need an alternate exit
- If we have time overruns our cost for capital may force an early exit
- Fire sale may be an alternative
- We should project to see if we can't sell what a hold looks like
- We may need to re-fi to liberate capital

Class Exercise

WE have a cost overrun of $8,000.00 for plumbing repair.

We are only 30% done with the project.

We were projecting a total $10,000.00 profit.

- ▶ Do We finish and sell at a possible loss?
- ▶ Fire Sale now and maybe break even?
- ▶ Rent property and hope appreciation bails us out?

Okay, so what about the buy hold investors? How do they know when to get out and how to do it? The income from rental properties is hard to pass up. It becomes tough to know when it is time to sell. Some folks want to hold properties forever. Is that the best allocation of capital though? To know when to get out we should look at the same formula we used to decide to get in. We used a cap rate. We did the cap rate based upon the purchase price of the property compared to the income the property generates.

Income / Purchase price = Rate of Return (Cap Rate)

In the new scenario we don't want to look to see what our original investment is earning but what our appreciated proceeds are earning. In other words, we need to determine what we would walk away with if we were to sell the property today and compare that amount to what the property is earning. That would look like:

Gross sales price
- Sales cost
- Mortgage payoff
= Proceeds of sale

The reason why we need to do this is because markets change, prices go up and end users (people that buy with the intent to live in the house) will pay more for a home than a cap rate will allow a reasonable investor to pay. If the market has appreciated then the amount of money I have tied up in the property in the form of appreciation will have increased. So my basis for comparison needs to look at: if I sold the property today how much money would I receive? How does that compare to a rate of return I could get from a different investment?

Example

- Investor bought a property for $80,000.00 and paid cash.
- The NOI when they bought the property was $7,200.00 per year
- Cap Rate 9%
- The properties rent has increased now and the NOI is $13,600.00
- Sales proceeds would be $310,000.00
- Cap Rate 4.4%

This leaves us set up to determine if we are able to beat a 4.4% rate of return in an alternate investment. In other words, is it time to sell and trade up? Answering this question lets us know if it is time to sell. We obviously need to make sure the investment is ready to attract a buyer for the price we are projecting our sales proceeds from. If so, we can sell our existing property take our new larger pile of cash and use a loan to get into something exponentially larger. This is how you build wealth in real estate.

The other thing to consider with your long-term income assets is how much depreciation do you have left. With residential properties we get to depreciate them over 27.5 years and non-residential over 39 years. If you are getting relatively near owning the properties for that length of time you may want to think of selling. You are about to have one of the better tax benefits of real estate go away. Once the property is fully depreciated you can on longer take a loss for the properties paper loss in value. This means that the portion of the income that this deduction was shielding from taxes will now be fully taxed. This makes me sad, so I would sell.

Class Exercise

Is it time to sell?

Purchase price _____

Cap Rate at purchase _____

Current NOI _____

Market value _____

Cost to sell _____

Proceeds of sale _____

Current rate of return on funds tied up in the investment _____

Conclusion

We have tried to look at the real issues that real estate investors face without sugar coating any of it. If this makes you less gung-ho to invest that is probably good. If it sounded easy before that is because they were not telling you the whole story. We have tried to show you what your exposures are and how to use the numbers to understand and manage those risks. Investing is a tough and competitive business. You need to know your stuff to be a true asset for your customer. You goal should be just that, to each day **strive to have the best information available to help your customers make the best possible decisions** when it comes to their purchases and sales of property. To be their true 'go-to' person for real estate.

For Chapter 1: Let's take a look at the following conversations

Conversation #1:

Josh (Agent): Hello sir, how can I help you? My name is Josh.

Alex (Investor): Hey I'm Alex. I'm interested in maybe picking up an investment property; just wanted to see what you had.

Conversation #2:

Josh (Agent): Hello sir, how can I help you?

Alex (Investor): Hey, I'm looking to maybe buy an investment property.

Josh (Agent): Awesome. By the way, my name is Josh. What's your name sir?

Alex (Investor): I'm Alex. How's it going?

Josh (Agent): Good to meet you, Alex. Alright so you're looking to buy an investment property. Do you know what area you're looking in?

Alex (Investor): Well, I like Hollywood. I live there I like the area; I think it's doing well.

Josh (Agent): Ok, cool. And how much money do you have to invest?

Alex (Investor): Well, we got right now about $300,000-

Josh (Agent): Oh, cool.

Alex (Investor): -from the sale of another property.

Josh (Agent): If you don't mind me asking, what do you do for a living?

Alex (Investor): I'm a teacher.

Josh (Agent): Oh, that's awesome man $300,000 as a teacher that's pretty, pretty impressive sir.

Alex (Investor): Yeah, we just downsized so we got some.

Josh (Agent): Oh ok, cool. So, you've always lived in Hollywood or you downsized from Hollywood?

Alex (Investor): I lived in Hollywood for like 30 years. My kids moved out so we sold the house because it was just too big for me and my wife and we just bought a smaller place.

Josh (Agent): Awesome Hollywood is a great area man we go down there all the time me and my Mrs. We actually have a dog, there's a dog park on Griffin 35th we go to.

Alex (Investor): Yeah, we go there with my Veesha.

Josh (Agent): Oh, that's awesome. We have an English bulldog puppy. We should definitely introduce the two.

Alex (Investor): Stocky.

Josh (Agent): Yeah. They would probably have a great time together; it would be fun to watch. Ok so you're looking in Hollywood. Do you have any preferences; a single-family home, condo, what are you thinking?

Alex (Investor): Well, a single-family home is what I guess I'm most comfortable with because I had one-

Josh (Agent): Sure.

Alex (Investor): -or, I have one.

Josh (Agent): And that matters. Cool and so we're looking at between, let's say $250,000 and $300,000 so that we're looking in the price range.

Alex (Investor): Alright, that sounds good.

Josh (Agent): Alright, we have 23 options that have come up right now on the market. So, if you want what we can do is I can go over these with you, I can show you the pictures of these, we could pick out a few that you might want to see and we can take it out there and we'll look at them, or, I can email them over to you and you can look on them at your leisure. You're here now it might make sense to go look at a few just so that we get a sense for what's going on in the market though if you want.

Alex (Investor): Yeah, I don't know how I would narrow down 23 properties.

Josh (Agent): If we put the pictures up, we can probably narrow it down pretty quickly.

Alex (Investor): Ok alright, we'll take a look at a few pictures, that would be good that way I know what's going on.

Josh (Agent): Cool, cool. Alright so you know what actually considering what time it is maybe we'll go grab a bite of lunch and we'll go have a look at a few of these properties and while we're at it, I'll get your information and I will set you up on an automatic email which is awesome because as soon as a new property comes on the market that matches your criteria, you'll get an email immediately.

Alex (Investor): Alright, cool or the bird gets the worm.

Josh (Agent): That's right pretty much. So, I guess the only question that's left is what would you like for lunch?

Alex (Investor): I don't know how about Chipotle?

Josh (Agent): Sounds like a plan.

Conversaton #3 - Non-Re Investor

Josh (Agent): Yes, sir how can I help you? By the way, my name is Josh.

Alex (Investor): Hey, I'm Alex.

Josh (Agent): Good to meet you, Alex.

Alex (Investor): I'm interested in investing in some real estate man.

Josh (Agent): Ok.

Alex (Investor): You know, whatever my financial adviser says I need to diversify so I was thinking of maybe buying a strip centre or something.

Josh (Agent): Cool, cool so what do you typically invest in?

Alex (Investor): Pretty much I've been a stock market guy-

Josh (Agent): Ok.

Alex (Investor): -my whole life. But we've been talking to a financial planner and he says that I have two allocated in one thing so he wants me to diversify and real estate has always been something I kind of looked at I thought was cool, and I'd like to own something like that.

Josh (Agent): Yeah, so be tangible like I can touch it.

Alex (Investor): Yeah so, I would be kind of keen, I think.

Josh (Agent): Alright, cool.

Alex (Investor): You don't get returns in but whatever.

Josh (Agent): What do you mean by returns in?

Alex (Investor): Well, I figure the stock market. Last year my stocks went up by 47%, I've averaged since I started like 12% maybe-

Josh (Agent): Ok.

Alex (Investor): -since I started investing in the market.

Josh (Agent): Ok when did you start?

Alex (Investor): I started about '92.

Josh (Agent): Ok so you went through the 2000s where it was-

Alex (Investor): Yeah, that kind of sucked.

Josh (Agent): What happened and then you've been making up grand in the last few years that's awesome.

Alex (Investor): Yeah, it's gone well for me. I'm blessed, I've managed to build up a good portfolio but whatever. My wife also doesn't like the risk so I figured real estate would be a safer thing even if it doesn't get me those types of returns.

Josh (Agent): Sure. So, it's good to keep it in the stocks that long because you're going to understand that how the stocks in the short term may not always look up the best play. If you invested in 2014 to now, you would look like a genius.

Alex (Investor): Yeah.

Josh (Agent): If you invested in 2000 to 2005, maybe you don't look so great, right? And so, the same situation kind of applies to real estate except that real estate is a bit more of a consistent market. I know we had 2008 with the recession and stuff, but if you look at the trends to where we are right now, we're right on pace to be where we would have been had that not happened. With all the down and all the back up again, kind of like what you saw on the stock market, it evens out over time. The thing is that what most investors tend to do when they talk to agents that don't know what they're doing, is they tend to look at a thing called the cap rate. And with real estate, when you invest in real estate, you actually have two sources of income. Cap rate only looks at one. Cap rate compares what we expend to what we get in rental income.

Alex (Investor): Alright.

Josh (Agent): So, with the stock it would be like how much of the stock will go up. Ok but also, we need to count in the dividend that the stock paid, if the stock paid a dividend and if we don't count in the dividend, we're not looking at the whole overall return. Does it make sense?

Alex (Investor): Yeah, of course.

Josh (Agent): So, with real estate, the dividend really is the appreciation of the real estate. And here's the thing, let's think about this, over time if you owned a rental property would you expect the rents to go up?

Alex (Investor): Definitely.

Josh (Agent): Ok so when we're looking at a cap rate what it's comparing is what we spent today vs how much income it makes today. If I use that to project forward and say well my property is making 10% today, well if the rents go up, I'm still comparing it back to the original purchase price, right? And so that means that that number is going to look continuously better and better as my rents go up.

Alex (Investor): So, the longer I hold the property the more money I'm making on property.

Josh (Agent): Better than that actually, theoretically, if your properties occupy the same amount of time throughout the length of the time that you want, the first year is always going to be your worst year in investing in real estate. It gets progressively better with time. The only limiting factor on the benefits, which I mean there's all sorts of benefits we could

talk about that are unique to real estate. One of the big ones being depreciation. If we're looking, I didn't even ask you I probably should have, do you have an idea of what property type you want to get into before I launch in this next thought?

Alex (Investor): Well, I was thinking of the strip mall you know.

Josh (Agent): Ok.

Alex (Investor): I had a buddy who told me that strip malls were good businesses. It sounded good to me, plus I like the idea of owning a strip mall.

Josh (Agent): Sure as, take your friends but this is my strip, got me thinking of my strip mall. Sure. Have you done anything like that before? What other business are you in?

Alex (Investor): I'm a teacher believe it or not.

Josh (Agent): Ok.

Alex (Investor): My wife's an accountant so she makes a lot more money than I do.

Josh (Agent): Awesome.

Alex (Investor): And we've been able to invest and put it away, but now it's time to like I said diversify a little bit. Now I also feel good because it's mine, I'm under control a little more.

Josh (Agent): Sure. You're getting to the point now where retirement is staring in the face and what are we going to do?

Alex (Investor): Yeah, I'm trying to get a little bit less risky with everything.

Josh (Agent): Sure, and real estate is very good for that. I mean there's always risks in real estate but the thing I was going to mention to you and the reason why I haven't asked that is because, the type of asset that you get is going to determine what kind of depreciation you get. So, depreciation is like what happens to your car; you buy it, it goes down in value.

Alex (Investor): Right.

Josh (Agent): But it's real, the car is literally worth less. In real estate, the real estate is actually appreciating but the government lets you save the value of the property when it went down and you get to take that as a loss in your taxes against the earned income. In other words, if you made $100,000 in stock, you'd have to pay tax on $100,000 if you were to sell, to look at your position, right? In real estate, if you made a $100,000 in income from rent, the depreciation is going to count as a loss against that. So, you're only going to show the Federal government $80,000 off that $100,000 you made; you're only going to be taxing the $80,000.

Alex (Investor): Right, that's good.

Josh (Agent): And you don't have to pay that back until you sell and there's ways to get around that even when you do so. So that is an advantage that real estate has over other investment

types. The other advantage that we have in real estate is money is extremely inexpensive to borrow in real estate. I'm sure that if you ever look at buying a margin, those interest rates are significantly higher than if we borrow money in real estate. The cool thing is, the interest portion of the mortgage payment is a tax deduction as well.

Alex (Investor): That makes it even cheaper.

Josh (Agent): It makes it even cheaper. So we could actually look at a purchase and then compare that purchase with financing and see what our rate of return would be based upon that financing, and then we could even go one step further and project forward what we could expect when rent increases in a property appreciation overtime based upon historical returns and you'll look at a property that you look at as a 6 or 7% rate of return and over a five year hold, that it could actually provide you with an annual of 16% rate of return.

Alex (Investor): Oh, damn. The bank statements are going to be great man.

Josh (Agent): Yeah. I'm no doctor but-

Alex (Investor): That's solid man considering less risk and all that, that sounds pretty good man. I would have to run the numbers with you because I got to see this. No offence too but you telling me is not the same as me actually seeing it how it works on paper.

Josh (Agent): 100% look, I get that. Luckily, you happen to be with a guy that loves running the numbers. I'm happy to show you exactly how this works. There's even more tax benefits, not just tax benefits but appreciation benefits to borrowing money in real estate. So, there's a bunch of things that we can look at with this. But yeah, I would be happy to go over it with you. This is the stuff I love, so yeah, I'd love to take and go over that with you. Let's spend some time and let's go over this and see where we are and what your budget is and move forward.

Alex (Investor): So, you think strip malls are good though?

Josh (Agent): It's going to really depend upon your comfort level with it. Understand every different investment type in real estate. If I said multi-warehouse, if I said office building, they are all very different businesses. So, if you have a friend that you said that's in the business and he's willing to take in and give you advice on what the leases need to look like and how you need to set that stuff up, sure that could be a good viable option for you. But I would say, for me, and that's where I would like to get a little more into the weeds with this stuff for you first. First, I want to show you the viability of real estate as an investment, and then we can get dived down into how we're going to minimise the risk for you. And what I mean is, I want to take and find a property type for you that's going to be most similar to something that you've experienced in your life, right? So, if that's residential, for most people it's residential right? Because they've lived in a house whether they rent it or they bought it, they have an idea of what's that like, what breaks, how much it costs when stuff breaks and all of these things; what it's like to be a landlord, what it's like to be a tenant, usually what's it like to be a tenant for most people, some of them have actually been landlords before, but as you said-

Alex (Investor): Right.

Josh (Agent): -you had the experience before. So, 100% I would say that's the place we want to start with this. One, make sure that you're comfortable with the investment of real estate and what it's going to do for you because I want you to know that what I'm telling you, I'm not making up. And then from there, we can take and target down to exactly what type of property is going to allow you to minimise your risk, going forward, based upon your experience. Does it make sense?

Alex (Investor): They could be the biggest returns.

Josh (Agent): Absolutely, absolutely, because returns are what's all about. At this point right, the returns are going to be what the returns are going to be. Let's take and figure out how to minimise the risk and then we can look at the different returns based on all of those things, you're absolutely right. There's two things that matter: risks and returns, right? And so, let's get at it.

Alex (Investor): Yeah, that would be great to be able to make a good profit on real estate man, let's do this man.

Josh (Agent): Sounds good.

Conversation # 4 - Good New Investor

Josh (Agent): Hello sir, how can I help you?

Alex (Investor): Hey how you're doing man?

Josh (Agent): My name is Josh, what's your name sir?

Alex (Investor): I'm Alex.

Josh (Agent): Good to meet you, Alex.

Alex (Investor): Hey I just came in here because I think I want to get into real estate investment and think about buying a rental property.

Josh (Agent): Cool, have you done any real estate investment in the past?

Alex (Investor): No.

Josh (Agent): Ok, great. So, there's a few things that we probably need to talk about just to kind of reference you in as to how real estate investment works. You haven't done any investment in the past, what do you do for a living?

Alex (Investor): I'm a teacher.

Josh (Agent): Ok, phenomenal. So based upon that unless there's some other life experience that I'm not aware of, your best bet is probably going to stick with residential real estate for your first investment. I don't know what you were thinking as for what you want to do for investment but that probably might be the best place to start.

Alex (Investor): Well, I was thinking of a single-family home just because that's what I've lived in my whole life so I figure I'm more familiar with it.

Josh (Agent): Sure, so the benefit that you have going in, are a few. One, because you've lived-in single-family homes, you kind of know what breaks in them, what goes wrong and all of those things. You also have the idea; I'm getting you've probably rented at some point in your life?

Alex (Investor): Actually no, I've moved straight from my parents' house into my own place, I didn't actually rent it.

Josh (Agent): Beautiful. So, you lived the dream end from day one that's awesome. One way or the other, the idea of living in a home, what it's like, all those things are familiar to you.

Alex (Investor): Right.

Josh (Agent): So, you're going to have an advantage over if I said hey let's go get you a dry-cleaning business or something like that which would be out of left field.

Alex (Investor): Yeah, definitely not.

Josh (Agent): Well, I mean there is a place for that too, there's some reasons to take in and look at that sort of investment as well later on. But to get your first investment under your belt and start making some money in real estate, 100% a good place to go. Are you familiar with the tax benefits this is going to give you going forward?

Alex (Investor): I know that there is some kind of depreciation and some other stuff maybe.

Josh (Agent): So, 100% there is depreciation. There is also benefits if we start to borrow money to take and invest, there is going to be benefits as far as being deduct more interest, there is all sorts of good things that we can look at. How much money are you thinking about that you want to work with?

Alex (Investor): Well, me and my wife just downsized recently because the kids moved out.

Josh (Agent): Ok.

Alex (Investor): So, I have like $300,000 just from the sale of the house and to downsize so I didn't want that to just sit in the bank so I figured real estate investing, I've heard good things about it I figured it would be a good place to try.

Josh (Agent): Absolutely. So, we have a few different things that we can look at with that, that is a pretty good chunk of money. We could look to get in putting that into one property or we can look into putting it in multiple properties or we could look into putting it into one property that is a multi-unit property.

Alex (Investor): Ok.

Josh (Agent): And the reason-

Alex (Investor): That sounds a little scary but ok.

Josh (Agent): Well, the reason why we want to do that is because there is a risk in real estate called vacancy risk and that risk is that at some point, the property is going to be empty between getting one tenant out and a new tenant in or whatever. That period you have no income for and that's a real risk to you.

So, one of the ways to minimise or mitigate that, I may use this word a lot mitigate because we're always looking to minimise risk for you, is to have multiple units. That way even if one unit is empty, your other units are still theoretically occupied and you're still getting income. All this takes and helps to minimise risk, it's the reason why I asked you what you do for a living. Right if you told me hey, I'm a doctor, I would say well you know what, maybe a medical office building makes sense for you or a residential real estate. You had experience living in residential real estate but you would also have experience as a doctor probably in a medical office, so we could again it's all this is designed to minimise your risk.

So, one of the questions that I'm going to ask you now is how would you feel about financing? And the reason why I say that is some of the best benefits of real estate, the tax benefits come from financing, it allows us to look at either more properties or larger

properties to spread out our risk over multiple units. If we could get you with that $300,000 a six- or seven-unit building, well that would take and spread your risk out over six or seven units. Yes, it might be a little bit more work and management wise, but there is a lot of benefits that we could look at as to why that this would financially benefit you in the long run.

Alex (Investor): Well, wow.

Josh (Agent): I know it's a lot to think about.

Alex (Investor): Yeah, I was looking at the single paying property, just buying one because I didn't want the extra risk involved with financing and getting a mortgage and all of that stuff.

Josh (Agent): Sure.

Alex (Investor): But I don't know man if you could explain to me why there would be less risk in financing and getting a more unit property, it sounds like I could make more money that way.

Josh (Agent): Sure.

Alex (Investor): Which would be a great thing. I'll take the extra money.

Josh (Agent): Believe it or not what it's going to do is going to reduce your taxable income, so you're going to have so much rent that you're going to make and look at through it how real estate is, only a portion of that rent is going to be taxable because we have the depreciation that you talked about. If we borrow money, whatever money we use to pay the interest portion that mortgage is also going to be tax deductible. So, all of that is going to be a benefit to you, to reduce the tax risk that you have, not the tax risk, the actual cost that you have of making money in real estate. And it's one of the benefits that it has over other investment types.

I know obviously you have to take and run this through the filter of hey I'm the realtor man out here and I make more money if you borrow money and invest. So obviously there is the sense that I have invested interest into getting you to spend more. I can show you; thousands sense wise why yes, I do make more money but one way or the other, my goal for this interaction even if you choose not to use me, is that you have a better sense of how this all works. Because look, I'm blessed in the sense that I don't need to do this deal with you to eat tonight. I always try to do my business in such a way that my customers know how it works better than the other customers out there. So even if they choose to use someone else, nobody is going to pull the wall over your eyes, you're going to know better than the other person out there, because that matters to me I believe in paying it forward.

So that being sense, let me go through and explain to you exactly what the benefits are for you, and from that I think you'll make your own determination. If you don't decide not to finance or whatever, that's fine. We can always just find you one property. I understand there's a sense that maybe that's less risky, but I think I can show you-

Alex (Investor): It's also a little scary with having six or seven units or whatever.

Josh (Agent): Sure, you go from having nothing to now having something, but there's even the option to have property management. That's what property management that takes all that risk off, not the risk but the aggravation off of you, but it also takes the risk off like hey I don't know how to do this thing. And the other thing is, I'm not going away. If you have a question, if you decide to manage it yourself and you have a question, I own a lot of real estate I'm happy to take in and give you answers and provide you with the answers every single time.

Alex (Investor): How has it been going for you to run a property business?

[00:06:16]

Josh (Agent): As it turns out man I'm very, very blessed. So that being said, let me take and spend some time with you and go over this with you and we'll go from there.

Conversation #5 - Experienced Investor

Josh (Agent): Hello sir, how can I help you my name is Josh, by the way.

Alex (Investor): Hey my name is Alex.

Josh (Agent): Good to meet you, Alex.

Alex (Investor): I'm just in the area I'm seeing if you have any properties that are good for investment. I'm looking for some rental properties, maybe you have something off market or something.

Josh (Agent): Sure.

Alex (Investor): I got $300,000 that I'm looking to invest in something.

Josh (Agent): Alright, cool. How much experience do you have in investing? How long, have you done it before?

Alex (Investor): Yeah, I've been doing single family home real estate stuff for 25 years. I got seven properties.

Josh (Agent): Oh, nice.

Alex (Investor): I got some portfolio going, it's going pretty well. I had a little bit of money saved up. I figure I could come in as a cash buyer and maybe find a good deal.

Josh (Agent): Sure. I mean there's some benefits to cash. There are, but there's also some downsides to cash that people don't usually talk about. So, it's something that we definitely want to look at because when you're a cash buyer obviously you don't take the benefits, some of the tax benefits that I'm sure you're aware, but the tax benefits that exist for borrowing money, also it doesn't allow you to spread your risk at a romotable profit.

Alex (Investor): Yeah, but I can get a better deal. When you walk in with cash, cash is king.

Josh (Agent): Sure, cash is king, but the question is whether or not, and this is the thing that we have to take and measure whether or not that benefit that you get outweighs the other benefits there are to spreading your money out over multiple properties. Again, I'm not going to tell you what to do, I'm just going to give you what the options are, that's kind of what I think my job here is supposed to be.

So, let's take a look at your portfolio.

Alex (Investor): So, you're trying to sell me three properties or four properties instead of one property?

Josh (Agent): Alex, let me tell you what my deal is. This is the agreement that I'll have with you, alright? I'm going to give you all the information, I'm not going to try to sell you anything. When we're done, if you choose to do business with me, cool. But what I want that, my goal for this conversation is for you to have an idea, the best idea possible of what's out there in the market to do; what your options are. So, we've looked at your portfolio from every possible angle so that you're best prepared to take in and you make your money work for you as best as we can. And I promise, no hard sale on my side at all, none, alright?

Let's just take a look at this and see where we are. So, I'm going to ask you some weird questions. I'm going to ask you some questions, maybe it sounds like it comes out of the left field, don't worry about it. At the end of the day, I will tie it all together for you, if you will give me that time.

Alex (Investor): Alright, I'll give you a shot, I'll give you a shot go ahead.

Josh (Agent): You'll give me a shot? Alright, cool. So let me ask you about your existing portfolio. What's the allocation, how much do you owe on, how much is cash?

Alex (Investor): I got like seven properties, I got three of them already paid off.

Josh (Agent): Nice.

Alex (Investor): Three in clear. The other ones, original loans were 75% loaned in value, I paid them down.

Josh (Agent): That's good.

Alex (Investor): So maybe the other three, 60% maybe.

Josh (Agent): Nice.

Alex (Investor): Something like that at ball park.

Josh (Agent): Beautiful, alright. So that's good, there is equity in those homes. Have you looked at thought about whether or not is time, and this is going, it always hurts my feelings when I say it, just to let you know it hurts me to even say it but I'm going to say it anyway. Have you looked at whether it's time to sell any of the properties?

Alex (Investor): No, why would I sell them? I'm making bank. Some of those properties I originally bought were renting for $800, they're renting for $1600 now. My cap rate is out the window, I'm making good money. Everything is going well; all I want to do is grow this thing.

Josh (Agent): Sure, and that make sense and maybe there's different ways to grow and this is the reason why I asked, right? Let's take a look at the numbers, you've just given me some. So let me go about my handy dandy calculator I'm such a big fan of. What did you buy your properties for originally?

Alex (Investor): Well-

Josh (Agent): Let's have the first ones.

Alex (Investor): Ok the first one I bought it for $80,000 that was a struggle back then to buy that.

Josh (Agent): Sure.

Alex (Investor): But, with time the rents go up. Now I'm getting like $1600 a month for it.

Josh (Agent): So, what do you think you're netting at $1600, in taxes and insurance?

Alex (Investor): About $800 after all, whatever.

Josh (Agent): Ok.

Alex (Investor): $800.

Alex (Investor): After all the real estate stuff.

Josh (Agent): We're looking at $96,000 a year.

Alex (Investor): Yeah.

Josh (Agent): Compared to what you bought it for, $80,000, at cap rate you're making 12%.

Alex (Investor): Yeah, if I can do that on all the properties, I'll be sweet.

Josh (Agent): You'll be killing it, absolutely. But here's the thing that we got to look at, right? Maybe there's a better use for that money.

Alex (Investor): Than 12%?

Josh (Agent): Well, let's see if it's really 12% because it's no longer $80,000, it's what we could sell the property for and get out of it. So, what do you think we could sell the property for now?

Alex (Investor): It's appreciated all it's due, it's probably like $300,000.

Josh (Agent): Probably better than $300,000, you'd probably walk away with $300,000.

Alex (Investor): Yeah, maybe yeah, it's paid off so why not.

Josh (Agent): So, here's the thing if I compare that $300,000 to what you're making, you're making 3.2% on your money.

Alex (Investor): `Wait, wait so you're saying that's not good.

Josh (Agent): It's not pretty.

Alex (Investor): So, you're saying what based on like if I bought the house now at $300,000 and was running it for this that's where I'd begin?

Josh (Agent): That's exactly what you're beginning with. So, here's the thing, what I'm actually saying to you is if what is another investment need to beat in order to be of better use of my existing money? Does that make sense? If I have my $300,000 in this versus something else, right? So that's where the cap rate is really good at. The cap rate gives us a good basis for comparison. It's saying, notice that word about appreciation. You and I both know appreciation is not in this number because if you sell this, you'll be putting the money in some other real estate investment, right? And so that-

Alex (Investor): That's the plan.

Josh (Agent): -being the case, we would be looking at the appreciation, the two things would probably cancel each other out, that's why we can just look at this quick number and say well, 3.2% is not that great.

Alex (Investor): Yeah. Definitely, not.

Josh (Agent) So, if we were to liberate the money from that investment, it might give us an opportunity elsewhere to take in and beat that 3.2% rate of return. Again, not trying to sell you more real estate man I'm not, I'm just taking and looking at the whole portfolio in general and seeing what our best option is.

Alex (Investor): Yeah, I wouldn't even look at that with that rate. I wouldn't touch anything under maybe seven, eight, maybe a six.

Josh (Agent): Right.

Alex (Investor): I wasn't even looking at that.

Josh (Agent): Right and that price point that typically is what happens with these homes, what happens is that people that buy the homes to live there, they pay more for the home so it doesn't make sense anymore, to take in and invest in them as rental property because of those low rates of return.

So, what we need to take a look at and do is figure out where you want to go with your investment. So, you were looking at doing a single-family home would you maybe be interested instead of buying one, maybe buying a few and borrowing money with your $300,000? Maybe, maybe it makes sense. I know you want to make the portfolio bigger, maybe it makes sense to get smaller to get bigger.

Alex (Investor): What I'm a little worried, you see the thing is I like to try to pay them all off to reduce my risk. That way, I don't have any, something goes vacant or something happens, I don't have any mortgage payments.

Josh (Agent): Sure. Of course, but there's always the risk of vacancy. Vacancy doesn't go away, but vacancy risk actually becomes less as you own more properties. One of the best ways to reduce vacancy risk, is to own more properties. Let's say if you owned a 1000 properties, your vacancy risk would probably perfectly match market vacancy which right now market vacancy is pretty well, it's like 2 or 3%, right? Well, you have seven properties. Are you ever at 2 or 3% vacancy? No because if you have one vacant property, you have more than 3% vacancy.

Alex (Investor): Ok.

Josh (Agent): Understand what I'm saying? So, it's the law of large numbers, it's like a kind of insurance company's work, right? They insure a whole bunch of people like for fire damage, let's say. They know houses are going to burn down but they know that if they have enough people insured, they're going to get enough premiums in there that it doesn't matter if those houses burned down. Same thing with real estate. The more properties you own, the more it spreads out your risk.

But, let's talk about the appreciation benefit of borrowing money. If I take your $300,000 and put it in one property and that property appreciates 3%, you have 3% growth on your $300,000, right?

Alex (Investor): Ok.

Josh (Agent): If I take your $300,000, I break it up and put it in three different properties, and each property appreciates 3%, do you get 3% appreciation on the $100,000 you put in or the whole $300,000 value of the property?

Alex (Investor): Yeah, yeah, I would have made $27,000 appreciation rather than $9,000.

Josh (Agent): Exactly. On the exact same money. And this is the reason why sometimes it makes sense to spread out the portfolio. Also, the rents go up on a percentage basis, typically rents are going to go up 2, 3, 4% a year, right? Well, if you have one property and they go up 3%, ok. If you have multiple properties, even though you only put down part of the money, you still get all the benefit of the rents going up.

Alex (Investor): Oh, alright.

Josh (Agent): And your mortgage payment is fixed. It doesn't go anywhere so it's a fixed expense. Then your other expenses increase but if you pay cash or you finance, they're going to increase the same amount anyway so it's a wash. We don't need to consider it. Does that make sense?

Alex (Investor): Yeah, yeah just I've always tried to pay off mortgages and pay them off and get them free and clear and own it.

Josh (Agent): Sure.

Alex (Investor): But yeah, it seems like I could be making more money if I were to finance it.

Josh (Agent): So, here's the thing. Maybe it makes, I'm going to throw in something crazy out there. Maybe it makes sense to sell a couple of the properties that you have right now and buy something significantly bigger, maybe a fifteen, twenty-unit building.

Alex (Investor): Wow. I thought about duplexes and triplexes and stuff but I never thought about well I mean I have thought of it but I didn't-

Josh (Agent): You didn't think you were a player in that.

Alex (Investor): Yeah, a player in that in that regard.

Josh (Agent): Sure.

Alex (Investor): We were talking, that is a property that is going to run for what a million, two million.

Josh (Agent): Oh, more than that.

Alex (Investor): Oh, great.

Josh (Agent): You see here's the thing, how much cash do you have right now? $300,000. If we were to sell a couple of properties, here's the other thing how long ago did you buy those properties?

Alex (Investor): It depends. I've been buying them for 25 years.

Josh (Agent): Ok so the depreciation, which is one of your tax benefits, runs out after twenty-seven and a half years, right? So, the tax benefit you're getting from that first property you bought 25 years ago, you only have two and a half years of depreciation left, and that's going to go away. So, this would be the time to do a ten-thirty-one exchange. Sell a couple of properties, you're not going to have a tax consequence, right? Go into a new property at a much higher basis, and take in and depreciate going forward. You once again pick up your depreciation, you'll still carry forward that lower basis that you have, but you'll pick up that much higher basis of the new property. So, it's going to bring that depreciation back into play again for you as a tax benefit.

So, it's just one little piece of this whole thing.

Alex (Investor): I don't like taxes.

Josh (Agent): I'm not a fan either, it comes directly out of profits.

So, let's say we have $300,000 that we have in cash, we sell a couple of property we do a ten-thirty-one exchange, right? Now we have $9,000. If we do a re-finance on the other assets that you have or we just finance the other property, we're well over a million dollars that we have right now to work with. We could buy a four, four and a half million-dollar property. Oh yeah. Add that to your portfolio, but now you're getting appreciation on a four-million-dollar property.

Alex (Investor): That's true, but that scares me having three million dollars in loans.

Josh (Agent): Of course, it does. The only time that it's ok to have three million dollars in loans is when you have five million dollars in assets, right? And that's kind of the place that we're talking about. I know we hear all the time stuff like debt is dumb and get rid of debt, all those kinds of stuff. But show me one billionaire in this country that doesn't have a lot of debt.

Again Alex, this is my position. I am not telling you to do what I'm saying right now. I'm saying it's an option, right? We can always step back, we can always say you know what, I don't want to go at 75% LTV on a property, but we can go 50% LTV.

Alex (Investor): But what do you think I could do, what do you think kind of a cap rate, what I can expect that of a big property like that?

Josh (Agent): Well, here's the thing. We're going to be looking at a cap rate, to begin with based upon a cash purchase, right? We're going to say hey look if I bought this for four million, if it's only making 6%, well that's not going to make anybody a lot of happy, but if we borrow money and that we're borrowing the money at 4%, well all of a sudden, it makes more sense. With big residential real estate, there's some very good loans where we could get money at very, very low interest rates below four, right? All of a sudden stuff starts to make a whole lot of sense with those numbers.

But here's the position that I want you to get to. I want to show you how far we could go, right? What the edges of what we can do with your portfolio are.

Alex (Investor): I think that's a pretty big step.

Josh (Agent): It is and we can always scale back, right? But my job here is to be the real estate professional. I'm supposed to know this stuff, right? So, my job is to show you what the big picture could be, and then for you to tell me they look these are the risks that I'm comfortable with so let's scale those back to here, right? And then while at the conversation I'll say alright well why are you worried about this, why you're worried about that, maybe to see if there is a way for us to minimise that risk, right?

But at the end of the day, it's all trying to maximise your return with giving you a risk that you're comfortable with. In fact, I think that honestly with a bigger property, you actually have a reduced risk even with that bigger loan, you're going to want it with a reduced risk.

Alex (Investor): Why?

Josh (Agent): Why? Again, lower vacancy. Your first year in investment property. Think about that. Your very first investment, one for $80,000 what were the rents back then?

Alex (Investor): $800.

Josh (Agent): Right, that was your worst year in that investment, right? Because what happened it actually ripped up the rent up $10. Now you're making $810 instead of $800. Every year

that you own an investment property, it's going to look better as time goes by. You know that as an investor, right? So, what we want to take and do, is we're going to look at your portfolio and see how we can take and get.

I always like to think about it this way. I always think about my Benjamin, my money sitting in the bank. Benjamin Frank was sitting in the bank is going to have a little umbrella drink and his little chubby belly sitting there by the pool, sipping away, while I'm out there slaying. You've gotten on the right side of the equation. You've got Ben, you're got him out there working. The question is whether he's working as best as he can for you and whether he's getting the most out of what he's doing for you. If we can figure out a way to take and keep your risk about where it is and at the same time expand your portfolio, you're going to experience a lot less in vacancy issues, you're going to have one location where you have a whole lot of units. So, that makes things a lot simpler to manage, right? If you have fifteen units in one place, it's much easier to manage, than if you got a house over here, a house over there, a house over there, right?

Alex (Investor): Yeah.

Josh (Agent): All of these things are taken out.

Alex (Investor): One roof. One yard.

Josh (Agent): I mean obviously we'll need to talk about things like reserves because it becomes a much more important, if you have a roof that's a $30,000 roof to replace to have reserved money set aside, but that's a problem you've been dealing with all this time anyway; whether you've been budgeting forward or not, right? So, we could talk about all these things, but I think what it's going to give you at the end of the day is a perspective that's going to be a little bit broader to take in more than your portfolio to decide which one you'd like.

Alex (Investor): Yeah, I came in here looking to see if you guys had a single-family home for investing and you're talking about all this other stuff, but it sounds interesting. If I get to take the money I got and make it work better. The 3% thing kind of-

Josh (Agent): Yeah, it hurt your feelings.

Alex (Investor): Yeah, it hurt my feelings.

Josh (Agent): I'm sorry.

Alex (Investor): But yeah, if I can get my money working better there is a lot to go in this. I got to wrap my head around it but it sounds interesting. Can we get together and talk some other time and figure this out?

Josh (Agent): Absolutely, absolutely. I'm happy to show you all the numbers to back up exactly what I've said. I want you to feel comfortable.

Alex (Investor): But I want to see some real-life examples so maybe you have other clients that have it or something I could kind of really see the numbers and how they work.

Josh (Agent): The cool thing is Alex, I'm an investor myself. I own a bunch of real estate and this is where I eat, breathe and sleep. I wouldn't do this if I didn't know what I was talking about and let me show you. I want you to not only see the numbers, I want you to understand how they work so that going forward you feel completely comfortable. And as I said, I'm fine doing this if you choose to work with me cool, if not that's ok as well. I just want to make sure that you're the best possible investor with the most options possible.

Alex (Investor): If I go home and tell my wife I want to buy a four million dollar building she's going to kill me, right?

Josh (Agent): Part of the consultation is if you want to bring your wife in, I'm happy to have a conversation with her as well.

Alex (Investor): Alright, thank you man. I will give you a call later.

Josh (Agent): Sounds good Alex.