THE ART OF CONTROL

REAL ESTATE OWNER'S MANUAL

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Inspired by a Mission to Give
Investors an Edge on Real Estate Investing

DEDICATION

To

Pharaoh

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CHAPTER 1
CHOOSING YOUR INVESTMENT PATH

The wonderful and sometimes vexing thing about real estate is that there are so many ways to make money. Single-family houses, apartment buildings, mobile home parks, assisted living facilities and public storages units have all taken investors from modest means to significant fortunes. When confronted with such a wide array of choices, deciding which of these paths to pursue can be overwhelming. But, before you can begin tracking down deals and making offers, you must first know specifically what you are looking for. You must choose a particular asset class to specialize in. In order to make this choice, you must have a way of evaluating the strategies that you will be exposed to and determining which strategy is right for you.

Remember that you are competing against other investors for the same deals. Many of these investors are laser beam focused on a specific niche. In order to successfully compete, you must be equally focused and knowledgeable about your investment strategy of choice. This chapter is intended to help you make an informed choice about your investment path, by enabling you to see how strength in one area can be offset by weakness in another area. A project that appears very profitable but is difficult to manage may be less prudent than a project that is moderately profitable but easy to manage. This is because profit margins shrink quickly when projects get out of control.

Your goal is to learn how to take all the factors into consideration as a whole before making your final determination because a well-chosen path enables you to get to your financial destination faster.

Short Term Gain v. Long Term Cash Flow

The first major decision is to decide whether you are looking for short-term gain or long-term cash flow. Short-term gain has the appeal of instant gratification. It can potentially put significant sums of cash at your disposal with 60-90 days. More importantly, it is sometimes the easiest way to get started. The downside is that you are only as wealthy as your last transaction. If not managed properly, flipping properties can result in a feast or famine lifestyle where a flood of money is followed by a drought that can cause economic hardship.

One way to avoid this outcome is to create a separate corporate account from which you pay yourself a monthly salary. This of course requires discipline and restraint but this approach can provide a more stable income stream, which can also be beneficial when applying for financing.

Regardless of how you manage the cash flow, flipping properties still requires the ongoing effort of identifying deals for your next transaction. It does not create long-term stability and therefore is not suitable as a retirement strategy.

Long term recurring monthly cash flow has the advantage of stability of income. Properties that afford a predictable stream of income are ideal for retirement planning as well as supplementing other sources of income that you may use to maintain your current lifestyle. Properties acquired for their income producing potential can, however, tie up significant amounts of capital that can dramatically slow down your ability to build momentum as an investor.

A blended approach that includes properties that are acquired for quick resale as well as properties that are acquired as part of a stable portfolio can offer the best of both worlds.

Project Viability

Regardless of whether you opt for short-term gain or long-term cash flow there are certain factors that will affect the success of your project. These factors fall into five main categories and together they determine the likelihood of your success in pursuing a particular investment path:

- Profitability: how much money do you stand to make from the project in question.
- Manageability: how much oversight will the project need and to what extent are you in a position to provide that oversight effectively.
- External Contingencies: how many of the factors required to ensure the success of the project are outside of your control; the more external factors that are outside of your control, the less viable the project.
- Time to Stabilize: how long will it take to restore the property to normal operations.
- Level of Experience: how much experience do you have running this kind of project.
- Level of Fulfillment: how much do you enjoy dealing with this type of asset

As you gain more experience you will be able to assess these factors as soon as you are presented with an opportunity. We will discuss each category in turn taking into account how they interact with other. The prudent path will be the one where as many of these factors are working in your favor as possible.

Profitability

In our discussion of number crunching in Chapter 2, we will cover in detail how we calculate the profitability of a particular project. What is important for our purposes here is how we view profitability as we are considering alternative investments. Profitability is just one of several factors that figure into whether a deal makes sense or not. A highly stressful deal that offers little other than a decent payday at the end may not be worth the headache. In addition, the amount of time it takes to achieve that profit must be considered. For example, let's assume you have the opportunity to flip a house and make $20,000 dollars. Currently you make $60,000 as a software developer. In order to find, research and flip this house would take an extra 20 hours a week for 6 months because the house needs significant renovation. As you consider this project you have to decide what your time is worth. Keep in mind that this extra 20 hours a week is on top of you current full-time job. In other words, for the same reason that overtime hours are compensated differently, you must view these additional hours as taking a greater toll than normal work hours.

There is no question that you have to pay your dues starting out and you will have to put in some extra time to get your investment business going. As a result, you might decide it is absolutely worth it to move forward with this transaction, even though on an hourly basis the compensation is comparable to your salaried position. The point is that you must go through the process of weighing the profit against the time commitment.

In addition to the value of your time, you should consider the return on the capital it takes to achieve this $20,000. Putting up $80,000 to make $20,000 is a 25% return on your money. Putting up $200,000 to make the same amount is only a 10% return on your money even though the net profit is the same in both cases. The return on the capital invested becomes particularly important when you are raising capital from money partners in order to get your deal done. Investors will compare the investment return you are offering to alternative investments that may be available to them. They will also weigh the risk that they are assuming by investing in your project.

The temptation as outsiders to the industry is to think that profitability is the most important consideration. As it turns out, it is often the least important. That may seem counterintuitive but the reality is that real estate transactions of every stripe make money. The question is whether you are in a position to effectively identify, analyze and manage the project such that you are able to realize its full potential.

To make sure you are successful, we want to make sure you have all of the bases covered.

TIP

Although money isn't everything, we are in this business to be profitable. If you have to do mental acrobatics to convince yourself of the profitability of a deal move on to the next one. Make 100 offers for every deal you accept.

Manageability

The Manageability Factor measures how challenging the project will be to manage effectively. Many a project that looked great on paper did not play out that way because of how the project was handled. Put another way, the same real estate investment strategy involving the same asset class, can produce a very different outcome depending on how it is managed.

Distance to the project can be one of the biggest obstacles to success. Despite your best intentions, if you attempt to take on a project as a new investor that is more than a 90-minute drive away from where you are based, you will find that the frequency with which you visit the project will drop dramatically. Infrequent visits create several problems. First, construction crews need constant supervision. So, if the project requires renovation, which most distressed property does, you will need to manage a construction crew. It never ceases to amaze me how different the work product is from a crew that knows that you will make frequent unannounced visits to the job site when compared to a crew that knows that you are out-of-state, for example, and can only occasionally fly in. The quality of the workmanship drops, the hours per day drops, the breaks get longer, the job site gets messier.

This tendency prevails even with crews that you have worked with for years and who know exactly what you expect. This is not to say that you cannot find contractors that are true professionals who will work to the same standard regardless of whether you make your presence felt--not at all. They exist. They are just more difficult to find, and you cannot assume that you will have the good fortune of finding such a contractor early in your career because you often have to go through several contractors before finding someone that you can really rely on. You must, therefore, assume that work quality will improve in proportion to the frequency of your visits.

An issue related to work quality is project direction. When you are not around for extended periods of time, contractors will often make critical decisions concerning the project that may not always be the right decision. In some cases this may result from poor judgment, but more frequently it simply reflects the fact that they do not have all the

relevant information. Let's assume, for example, you buy a mobile home park with 20 units in need of repair. From a cash flow perspective it is critical that each unit is completely remodeled before the crew moves on to the next unit. This way, you can begin marketing units in order to start receiving the income you need to service the mortgage on the property. You thought you made this clear to the general contractor in your initial meeting before the job started. Apparently not, because when you return two weeks later you discover that the contractor thought that it would be more efficient to haul the trash out of all the units and complete all the demolition work at the same time. Now, was that wrong thinking on the contractor's part—of course not. In fact, it might very well have been more efficient to do all the demo work, then all the electrical work, then all the plumbing work, etc. The problem with that approach, however, is that it might be months before even the first unit is complete. This approach will result in all the units being completed at approximately the same time, which is a perfectly efficient way to renovate the units; it just doesn't provide you with any cash flow in the interim. Only you can ensure that a project stays on course, because only you have all the relevant information to know what course will result in the best overall outcome.

The absentee owner problem can also provide challenges with tenants in larger buildings (i.e., 8 or more units). Tenants, like contractors, seem to have a sense for when they are dealing with a landlord who will be unable to manage them effectively because of an inability to make regular appearances at the building. This could result in occupants not listed on the lease moving into the unit, inappropriate use of the common areas and parking spaces, and untimely payment of rent.

TIP

Ideally, you would visit the job site at least once a day to make sure things are running smoothly. If you cannot visit the project more than one a week, you may be heading for trouble.

External Contingencies

An external contingency is something that is necessary for the success of your project, but that is outside of your control. Common external contingencies would include:

> Permit approval: new construction requires permits to be approved by the local municipality and as we all know political winds shift often. Elected officials that might be in favor of your project today might be replaced by officials that are not so inclined tomorrow.
>
> License approval: certain real estate investments, like residential care facilities, require state licensing, which can take many months to be approved. This license approval timeframe must be factored into the overall project timeline.
>
> Variances: a variance is essentially an exception to the local ordinances, which may under some circumstances be granted by the local municipality. A common example would be a variance to have fewer parking spaces than otherwise required.

As a general rule, the more external contingencies that have to be satisfied in order for you to proceed with your intended project, the more holding costs, legal fees and other administrative fees you will incur. These fees can be difficult to accurately budget for and can result in cost overruns and time delays even for the most experienced real estate investors and developers.

TIP

When getting started, avoid projects that have multiple external contingencies. Focus instead on projects where you can control as many of the factors as possible.

Time to Stabilize, Reposition or Renovate

The longer it takes to stabilize, reposition and/or renovate a property, the greater the right of cost overruns and unforeseen problems. Separately identify the costs and time associated with each activity to get a better sense of what you are truly up against.

> *Stabilizing* a property means getting it back under control. The best deals will often be distressed properties. A distressed property is a property in crisis for one reason or another. For example, the Home Owner's Association might be assessing fines because the lawn is overgrown and the fence has blown down. Stagnant water in a pool could be creating a health hazard. Structural problems might be making the property unsafe to move around in. Problems like this must be addressed immediately before taking the necessary steps to turn the property around. Often the cost to stabilize a property is either overlooked completely or lumped in with renovation costs. The reason these costs need to be identified separately is because the urgency with which these problems need to addressed can sometimes result in higher than normal expenditures.
>
> *Repositioning* a property means changing something about the property to maximize its profitability. A typical example of repositioning a property would be expanding the hallways of a single-family residence to make it suitable as a residential care facility. Repositioning often requires additional services like architectural or engineering services, which in turn typically require city approvals.
>
> *Renovation* refers to both functional and cosmetic repairs. Functional repairs include upgrading the electrical system from fuses to circuit breakers and upgrading the plumbing from galvanized to copper piping. Cosmetic repairs include new paint and new carpet. The more functional repairs the project requires, the more costly and unpredictable the overall renovation.

Remember that stabilization, repositioning and renovation must all be completed before the property can realize its maximum market value for resale or maximum rental potential for cash flow. If there is debt

encumbering the property, mortgage payments will have to be made while the property is either generating no income or suboptimal income. Even without mortgage payments, cost overruns can break a budget quickly.

TIP

When getting started, avoid projects that will take extensive periods of time to stabilize, reposition and/or renovate. Prefer projects that require light, cosmetic work because this type of work can be done quickly and is highly predictable

Level of Experience

The lessons of experience can only be learned by doing. Every project will present different challenges and opportunities. As a result, the more familiarity you have with an asset class, the more problems you can anticipate and avoid to ensure the deal is successful. When considering your investment path you will be at an advantage if you have some knowledge of the field even if you haven't actually been involved in a transaction of your own. If you have been a nurse in a residential care facility, it will easier to get up to speed on what it takes to make such a facility successful. If you are a general contractor who has been renovating homes for investors, it will be easier to create a budget for your own deal.

If you have no personal experience with a certain asset class, you should consider whether there is anyone in your immediate circle of family and friends that might be willing to collaborate with you on a project. Having someone that you can trust will reduce the level of oversight you will need on the project. Even if this person does not want to directly participate in the deal, they may be willing to act in an advisory capacity.

Even if you are venturing out for the first time into the world of real estate investing and have no experience with the asset class, you can still be successful. You must, however, spend more time carefully building the team that you will work closely with on a daily basis. Since you will be relying on their experience and their ability to accurately assess the viability of the project. You must interview them carefully to make sure their skill sets fit what you need.

It will also be important for you to be confident in dealing with seasoned professionals. Ultimately it is your deal and everyone involved needs to bear that in mind.

The less experience you have, the smaller the project you want to start with. This way, to the extent you make mistakes, they will be less costly mistakes that you can learn from without significant financial impact. Grand ambitions are fantastic, but the real estate market isn't going anywhere. Small methodical successes will serve you better than going

for the homerun too soon. Learn the industry, become an expert, and the industry will serve you well.

TIP

Your first three deals are more about gaining experience and perfecting your process than they are about making major profits.

Level of Fulfillment

Ultimately, there must be a degree of satisfaction in your investment activities or you won't be motivated to persist. We tend to avoid things we find unpleasant or stressful. In the context of real estate investing, this means we will visit the property less often. We will be less inclined to take calls concerning the property or deal with problems. For obvious reasons, reluctance to deal with a property can be disastrous.

We must be honest about whether our personality is suited to the type of asset we are considering. If, for example, we know that we are not the type to confront a tenant in a mobile home and demand overdue rent, we must recognize this disadvantage. It could be that mobile homes are not the right fit regardless of how profitable they might be and we ought to take that into consideration as part of the overall decision-making process. Just because a particular investment strategy proves tremendously successful for one person doesn't not mean you will have the same experience.

In addition, the more an investment path feels like a tedious 9-5 job, the more likely we are to burn out. If you find yourself working 60 hours a week fixing leaks, evicting tenants and fighting with utility companies, your enthusiasm might wane over time. This is not to say that investing should be all fun and games. But, it should be a rewarding experience. You should be excited about learning more about the asset class that you have chosen to specialize in. You should be motivated to research and learn more about the industry. Investing in real estate can and should be exciting.

TIP

Although we want our deals to be profitable, we must also find fulfillment in what we do to be motivated to excel.

Establishing Your Investment Parameters

The final step once you have chosen an asset class to pursue is to establish your investment parameters in order to further narrow down your search. Investment parameters are the criteria that you will use to define your searches.

Residential Criteria Include:	Commercial Criteria Include:
Price Range Bed/Bath Count Interior Square Footage Lot Size Age	Cap Rate Range Total Unit Count Unit Mix Age

There are a plethora of leads out there and without relatively specific parameters your inbox will be flooded with leads from websites and brokers. You will also find real estate agents and birddogs more willing to work with you when you know what you want.

One of the more important ways to zero in on what to look for in a particular market is to identify properties that represent the typical properties in that market. In other words, avoid the peripheries of the market. By this I mean avoid the one-of-kind architecturally unique house nestled in the hills that has no comparable sales. It is extremely difficult to predict how the market will respond to niche properties like this. At least initially, you want the typical house that the typical buyer will buy. You want the typical mobile home that the typical renter will rent. Renters, for example, will not necessarily pay a premium for the massive double-wide trailer with an island in the kitchen if nothing else in the park looks like that. And even if they are willing to pay a little more, they will rarely pay enough to justify the additional expenditure for such a unit.

TIP

Keep your parameters in the middle range of the market both in price and in characteristics.

Notes:

CHAPTER 2
CRUNCHING THE NUMBERS

Not fun but so necessary. I cannot overstate the importance of getting familiar with the basic ratios and formulas you need to determine whether a particular property is a good investment. If you are not good at math, get better at it. Take a class if you need to, but DO NOT rely on somebody else to tell YOU whether an opportunity makes financial sense or not. Even with the assistance of spreadsheets that greatly simplify the financial analysis portion of assessing deals, you should still understand the formulas that were used to create the spreadsheets and how to interpret the results generated by the spreadsheets.

Single-Family Residence Flips

Determining whether the flip of a single-family house will be profitable seems relatively easy but do not do the math in your head unless you have significant experience flipping houses. You will be surprised at how a mountain of built-in equity can be eroded by closing costs and renovation costs.

The basic steps you will need to take to calculate how much money you will make from flipping a property are as follows:

STEP 1: Total Acquisition Costs—Tells you how much money will you need to purchase property.

Purchase Price
+
Closings Costs (loan fees, title fees, lawyer/escrow fees, etc.)
____
Total Acquisition Costs

Couple of points here. The first is that it is useful to look at what percentage each of the closing costs categories (e.g., title fees) represent of your total purchase price because this is a quick way to shop companies to make sure you are not overpaying for closing costs.

Second, remember that these acquisition costs will be offset by the amount of loan proceeds you will be receiving as well as other potential credits from the seller.

STEP 2: Total Holding Costs—Tells you how much money you will need to sustain the property as you prepare it for resale.

Debt Service
+
Stabilization, Repositioning or Renovation Costs

Total Holding Costs

The longer your transaction timeframe the more these costs will continue to grow. Be sure that you have adequately budgeted for these costs because an unfinished home can typically only be sold to another investor who will want a discount that will essentially wipes out your profit and potentially cause a loss.

STEP 3: Total Capital Outlay—Tells you how much money you will need to carry you through the entire project.

Total Acquisition Costs
+
Total Holding Costs
___
Total Capital Outlay

This amount of money must be in your account at the commencement of the deal because it must carry you through the entire project. This is also the amount you will use to calculate the return on your investment at the end of the deal.

STEP 4: Net Profit—Tells you how much money you made on the deal net of the money you put in:

Sales Price
-
Closing Costs
___
Net Sales Proceeds

Net Sales Proceeds
-
Total Capital Outlay
___
Net Profit

STEP 5: Return on Investment—Tells you the percentage return on your money:

Profit/Total Capital Outlay = Return on Investment

A very important number to pay attention to when calculating the projected profit on a deal is the Breakeven Price. The Breakeven Price is the sales price at which you will pay off all the transaction costs and recover all of your money from the deal. Calculated as follows:

Sales Price
-
Profit
____
Breakeven Price

Remember that you will succeed in this business as long as you live to fight another day. At a certain point, the best course is simply to get your money out of a deal and move on to the next one. The Breakeven Price tells you how much you can drop the price before you start losing money.

Income Producing Properties

We will spend the remainder of this chapter reviewing the core analytical tools you will need to make well-informed investment decisions. Bear in mind that there are varying opinions on which ratios are the most important. No doubt you will form your own opinion over time and weigh in on that debate at some point. My objective here is not to make a case for some hierarchy of real estate financial ratios. They all impart useful information. What's important is that you use some prudent combination of the most common ratios and formulas and that you have a firm understanding of the information they convey.

In this section we will discuss the following ratios:

Net Operating Income (NOI)

Capitalization Rates (Cap Rate)

Gross Rent Multiplier (GRM)

Price Per Unit and Price Per Square Foot

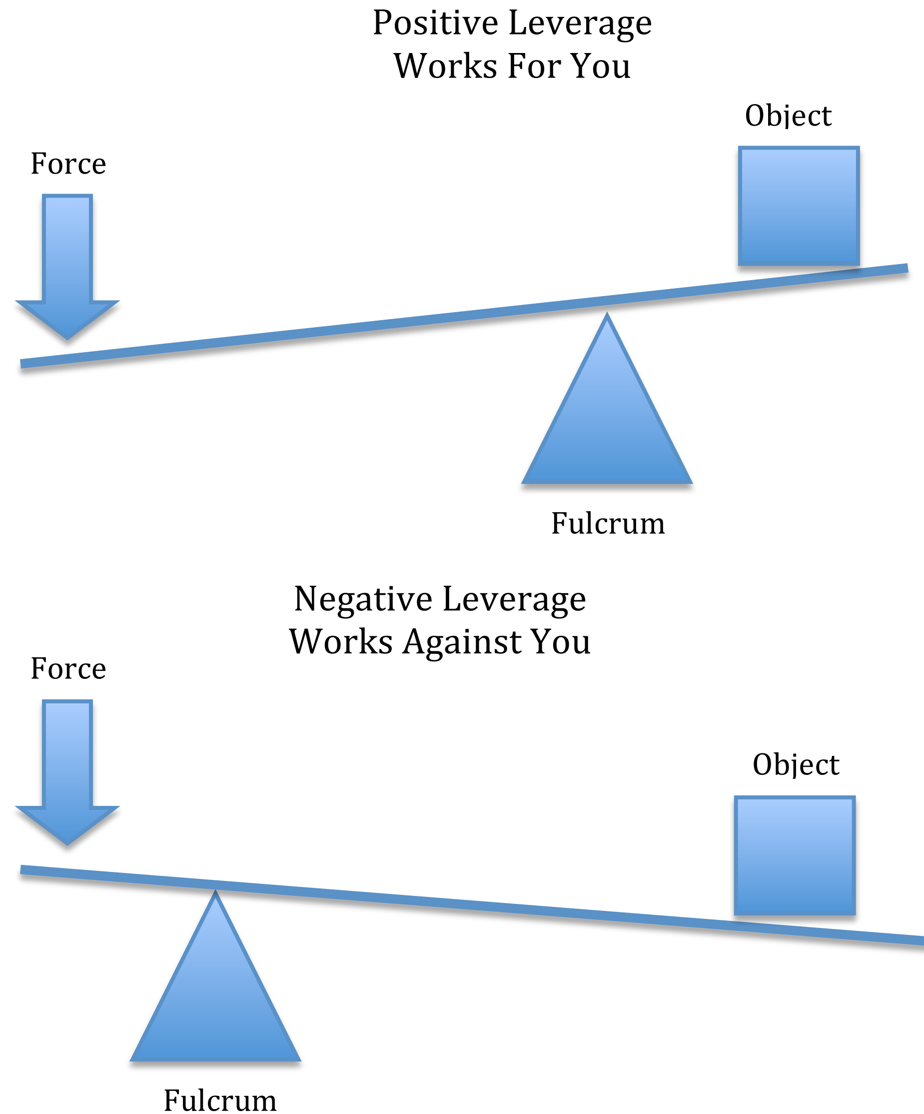
Return on Equity (ROE) or Return on Investment (ROI)

Internal Rate of Return (IRR)

But before we turn to the discussion of the ratios, we need to briefly review the concept of leverage. To better understand how financing can help or hurt the overall performance of an income producing property.

Leverage

In order to more fully grasp the discussion of important financial ratios and formulas, we need to quickly review the concept of leverage. A lever is a simple mechanism consisting of a bar pivoted on a fulcrum (or fixed point) that allows you to exert force either more or less efficiently.



As you can see from these illustrations, not all leverage is good.
In the financial world, positive leverage can increase your overall return dramatically. Negative leverage can decrease your overall return dramatically. The examples below illustrate the point.

Positive Leverage

Without Financing
Purchase Price: $1,000,000
Net Cash flow: $100,000
Return on Investment (without financing): 10%

With Financing (Positive Leverage)
Purchase Price: $1,000,000
Loan: $800,000
Interest Rate: 6%
Down payment: $200,000
Cash flow: $100,000
Debt Service: $48,000 (Interest Only)
Net Cash flow: $52,000
Return on Investment (with financing): 26% ($52,000/$200,000)

The easiest way to tell that this is a positive leverage situation is that the interest of 6% is lower than the return on your investment of 10% if you paid all cash. This means that the cost of getting money to invest in this project (6%) is cheaper than what the property is generating (10%). As a result, every dollar of outside capital increases your return. In fact, the way to figure out exactly how much your return will increase is:

Step 1: Figure out the difference between the cost of funds and the unleveraged return.

Unleveraged Return = 10%
Costs of Funds = 6%
Costs of Funds Spread = 4%

Step 2: Figure out how much more money the lender is putting up as a multiple of what you are putting up.

Loan Amount = $800,000
Down payment = $200,000

Leverage Factor = 4 (i.e., $200,000 into $800,000 is 4, so the lender is putting up four times more money than you are)

Step 3:
Multiply the Cost of Funds Spread (4%) times the Leverage Factor of 4 to get 16%. This means that the financing we added to this property increased the overall return by 16%. Since the unleveraged return (i.e., the return prior to securing financing) was 10%, the financing increased the return to 26% (10% plus 16%).

If the lender put up $900,000 and you only had $100,000 in this property, the Leverage Factor would have been 9 and the overall return would have increased by 36% (9 multiplied by the 4% Cost of Funds Difference) for a total return of 46%!

If this much math makes you nervous, you might consider teaming up with someone who is more comfortable with math. What is most important, however, is that you understand conceptually how leverage works. Positive leverage ratchets up your return just like the bar helps you lift the box in the diagram above. Now let's see what happens when there is negative leverage.

Negative Leverage

Without Financing
Purchase Price: $1,000,000
Cash flow: $100,000
Return on Investment: 10%

With Financing (Negative Leverage)
Purchase Price: $1,000,000
Loan: $800,000
Interest Rate: 12% (note that interest rate is higher than 10%)
Down payment: $200,000
Cash flow: $100,000
Debt Service: $96,000 (Interest Only)
Net Cash flow: $4,000
Return on Investment: 2%

Step 1: Figure out the difference between the cost of funds and the unleveraged return.

Unleveraged Return = 10%
Costs of Funds = 12%
Costs of Funds Spread = -2%

Step 2: Figure out how much more money the lender is putting up as a multiple of what you are putting.

Loan Amount = $800,000
Down payment = $200,000
Leverage Factor = 4 (i.e., $200,000 into $800,000 is 4, so the lender is putting up four times more money than you are)

Step 3:
Multiply the Cost of Funds Spread (-2%) times the Leverage Factor of 4 to get -8%. This means that the financing we added to this property decreased the overall return by 8%. Since the unleveraged return was 10%, the financing decreased the return to 2%.

Keep the concept of leverage in mind as we now begin discussing important ratios and figures.

TIP

Don't buy properties where the cap rate is lower than the prevailing interest rate.

Net Operating Income (NOI)

NOI is one of the most important figures to be familiar with because it is the basis of other key ratios. NOI is calculated as follows.

Gross Income (total rents collected)

Minus Vacancy Factor (percentage of gross rents based on vacancy rates in the area or historical vacancy rates for this building)

Equals Effective Gross Income

Minus Operating Expenses (utilities, taxes, insurance, etc.)

Equals Net Operating Income (NOI)

The most important thing to note in this formula is that NOI doesn't take into account debt service (i.e., mortgage payments). In other words, NOI will not tell you what the actual cash flow of the building is if the building is encumbered by a mortgage. The actual cash flow will be NOI minus the mortgage payment. The reason NOI doesn't take into account mortgage payments is because NOI is intended to help you determine what the unleveraged performance of the building really is. You need to understand how the building performs without leverage in order to determine whether the financing on the building is helping or hurting.

As you can see from how NOI is calculated, the NOI figure is only useful if the data that goes into calculating it is accurate. If the operating expenses are understated (as they often are), NOI will be overstated. If the vacancy factor is understated (as it often is), NOI will be overstated. Your job is to ensure that these figures are accurate or that you have useful plug figures to use if the data you are given by the seller is either incomplete or suspiciously rosy.

Capitalization Rates (Cap Rate)

The cap rate is basically the return you would get on your investment if you bought the property all cash. It is a critical ratio to be familiar with when analyzing income producing properties and it is derived by dividing NOI by the purchase price and expressing the result as a percentage as follows:

Cap Rate = NOI/Purchase Price

For example, if you purchase an apartment building for $1,000,000 that has an NOI of $100,000 per year, the cap rate would be 10% ($100,000/$1,000,000=10%).

Cap Rate = NOI/Purchase Price

Another way to express the cap rate ratio is as follows:

Purchase Price = NOI/Cap Rate

The relevance of expressing the cap rate this way is that it more clearly shows that the lower the cap rate, the more you will pay for a property with exactly the same stream of income.

Building A: $1,000,000 = $100,000/10%

Building B: $2,000,000 = $100,000/5%

Building A and Building B have exactly the same income stream, but by lowering the cap rate from 10% to 5% we doubled the value of the Building B. This is an extremely important point to grasp. Here's why. The investor who buys Building B is paying twice as much for the same income stream ($100,000) as the investor who buys Building A.

You might ask yourself why would any rational investor pay more for the same income stream. Cash is cash right? Well, when I first started acquiring apartment buildings they were in the same less than desirable areas as the one I lived in as a child. I went to some of the lawyers I was working with at the time and said "Hey, I found a building that has a

12% cap rate. Cap rates for the same cash flow across town are trading at a 6-7%, which means we are essentially getting the property at a 50% discount. Do you want to go in with me to buy it?" Consistently the answer was "Well, that's not a great area. There is probably going to be a major vacancy problem because of tenant instability."

Think about this objection for a moment in light of how cap rates are calculated. The cap rate of a building is a function of the NOI and NOI is net of vacancy. In other words, the 12% cap rate already takes into account whatever vacancy may be attributable to tenant instability or any other reason.

Needless to say, I acquired the buildings anyway and they turned out to be immensely profitable. Part of the reason I remind people to leave ego and emotions out of real estate investing is because if you are buying a building because you want to be able to take pretty pictures that you can show to your friends, you might not always be making the right investment decision. You are not going to live in the building. If you have a competent property manager, you will not even be visiting the building.

Let's return to our two buildings again to discuss another important point.

Building A: $1,000,000 = $100,000/10%

Building B: $2,000,000 = $100,000/5%

Let's say you bought Building B at a 5% cap rate because a commercial broker convinced you that you just had to have this pretty building in your portfolio (many investors bought buildings like this in 2007 and 2008). Assume that you put 20% percent down and financed the balance of the purchase ($400,000 down payment, $1,600,000 loan).

Look at what happens to your down payment as cap rates click upwards.

Building B: $2,000,000 = $100,000/5%

Building B: $1,820,000 = $100,000/5.5%

Building B: $1,667,000 = $100,000/6%

As the cap rate increases from 5% to 5.5% to 6%, the property value drops from $2,000,000 to $1,820,000 to $1,667,000. So you now have a building that is worth $1,667,000 with a loan of $1,600,000. In other words, a 1% increase in cap rates wipes out your $400,000 downpayment!

The reason that a click upwards is inevitable when cap rates get down to the 5% ranges is because of the concept of opportunity costs. Investment opportunities compete for dollars. If an investor can buy a municipal bond that yields 5% with little risk, they will require a higher yield on your building to justify the increased risk associated with it—the higher the perceived risk, the higher the cap rate. It is a rare and fleeting moment in real estate history when an apartment building is perceived to have the same risk as a municipal bond.

In addition, if you buy a building with a cap rate that is below interest rates you have locked in negative leverage for anyone looking to buy that property from you using financing. Since most buyers secure financing to buy investment properties and since most buyers will not accept negative leverage, they will reduce their offer to the point where the cap rate is once again higher than the prevailing interest rates. In other words, you will have to accept a significant reduction in purchase price to sell the building to someone getting financing.

TIP

Cap rates that are driven to excessively low levels will be buoyed back up by the upward pressure of interest rates. So if you buy an income producing property for a low cap rate, you run the significant risk of equity loss.

Gross Rent Multiplier (GRM)

GRM is calculated by dividing the gross rent into the purchase price and expressing the result as a numeral as shown in the following formula:

GRM = Purchase Price/Gross Rent

If you purchase an apartment building for $1,000,000 that generated gross rents of $125,000 per year, the GRM would be 8.

Investors sometimes make the mistake of alternatively choosing to use either the cap rate or the GRM to analyze a building on the assumption that both ratios measure essentially the same thing because they are both a measure the income of the building against the purchase price.

This is a very serious misconception that can lead to costly mistakes. Remember that the gross rent is the rent prior to the deduction of a vacancy factor and operating expenses. Therefore, the GRM doesn't measure the unleveraged return on your money. What it really does is give you a way of quickly determining how much you are paying for the building per dollar of rent in comparison to what comparable buildings are commanding. In other words, it is a quick way of doing sales comps on income producing buildings as opposed to really determining your actual cash flow.

As with any other measure tied to rents, GRM will not be a reliable measure for a building that has significant vacancy because of poor management. As it turns out, however, these are precisely the buildings you might end up targeting because they have significant upside potential. In such cases, you will need to create a pro forma analysis of the building, which means projecting what the gross rents would be based on rental comparables for the area assuming the building were properly managed.

Price Per Unit and Price Per Square Foot

Price Per Unit

Price per unit, sometimes referred to as price per door, is calculated by simply dividing the purchase price by the total number of units in the building. The challenge with this ratio is that it doesn't account for unit mix typically. For example, a 30 unit building selling for $1,800,000 has the following unit mix.

10 one bedroom/one bathrooms
10 two bedroom/two bathrooms
10 three bedroom/three bathrooms

The price per unit ratio tells us that the building is selling for $60,000 a door. The problem is that it assigns the same value to every door. To understand why this can be a little misleading consider the following building:

5 one bedroom/one bathrooms
5 two bedroom/two bathrooms
20 three bedroom/three bathrooms

This building has twice as many three bedroom units and, everything else being equal, is probably a more valuable property than the first property. However, the price per door is still $60,000.

If you are planning to use this ratio to compare two buildings it will be more useful if the two buildings in question have a similar unit mix.

Price per square foot

This ratio is more commonly used for other asset classes and is very useful for buildings that have relatively uniform square footage usage such as industrial buildings or public storage facilities.

Return on Equity (ROE) or Return on Investment (ROI)

Although some other ratios may be more useful from an analytical perspective, ROE will certainly be the most important ratio from your money partner's perspective. The name of this ratio, however, is a little bit of a misnomer based on how it is normally used by practitioners in the real estate industry. In practice, it is not used to measure the return on the equity in the building (which might have increased as a result of appreciation); it is used to measure the return on the cash invested in the building. Therefore, Return on Investment is probably the more accurate term, and it is how I will refer to this ratio in this course. Just keep in mind, your prospective money partners may be more familiar with the term ROE.

Typically, listings will not include ROI information because in order to calculate it you need to know how much cash will be used to acquire the property. If the property is being acquired all cash, capital investment equals the purchase price. If financing will be used, the capital investment equals the down payment.

ROI is calculated by first subtracting any mortgage payments from the NOI to arrive at the monthly cash flow.

Gross Income (total rents actually collected)

Minus Vacancy Factor (percentage of gross rents based on vacancy rates in the area or historical vacancy rates for this building)

Equals Effective Gross Income

Minus Operating Expenses (utilities, taxes, insurance, etc.)

Equals Net Operating Income

Minus Mortgage Payments (if applicable)

Equals Cash Flow

Then, you divide the Cash Flow by the Capital Investment and express the result as a percentage.

ROI = Cash Flow/Capital Investment

Typically, when I calculate ROI, I actually use the total amount required to get the deal done, including other acquisition costs like escrow/title fees and initial stabilization costs.

ROI is what most investors will use to compare your opportunity with alternative investments they may be considering. You should do the same thing. Once you have determined the ROI, make an honest assessment of the risk associated with achieving that ROI. How many contingencies do you need to go in your favor for the property to perform as you are projecting (licensing, permit approvals, etc.)? How many of those contingencies are within your control? How many might require the expenditure of additional funds?

Be ready to walk from a particular investment opportunity if the numbers don't pencil out. You will save yourself and your money partner unnecessary stress and aggravation. This is energy you could be using to find a better deal. It can take years to extricate yourself from a bad deal whereas it might only take a few weeks to tee up another deal.

Internal Rate of Return (IRR)

IRR is a more holistic way of calculating the ROI. ROI is really more of a snapshot of the building's cash flow in a given year as compared to the money invested in the building. IRR is intended to measure the overall return on the investment from the time you put your money in until the time you get all of it back several years later. It is typically used to analyze investments that will be held for a period of years.

Essentially, what IRR tells you is what rate of return you would receive on your money per year over a certain period of years given certain annual cash flow (or lack thereof) plus net proceeds at the time of sale (or lack thereof). Let's assume you acquired an apartment building with a $200,000 down payment, the building generated $20,000 per year for five years, and then you sold it and netted $260,000.

Year	Cash Flows	Description
0	-$200,000	Initial Down payment
1	$20,000	Annual cash flow
2	$20,000	Annual cash flow
3	$20,000	Annual cash flow
4	$20,000	Annual cash flow
5	$20,000 + $260,000	Annual cash flow + Sales proceeds

The IRR for this building would be 14.5%, which is roughly the equivalent of saying that you got a 14.5% return on your money for the five years that you had it invested in this building plus you got all of your money back.

The question is how did I get 14.5%. IRR is a relatively complicated formula to use because it involves an iterative process of guessing at the rate of return until you arrive at the right number. I would recommend either learning how to perform this function in a spreadsheet or on a financial calculator as opposed to computing it manually. In addition, you must really know what you are doing to use IRR when acquiring a building because it requires you to project how long you will hold the building, what your annual cash flows will be, and what sales prices you will receive several years down the road. Unless you are comfortable making these projections, use ROI.

The Two-Step Filtration Process: Cap Rate and GRM

I often use the GRM and cap rate together as a two-step filtration process—a one, two punch as it were. When a real estate agent offers me a building, I use the GRM as my initial screen to determine whether I should go any further in my analysis. It will eliminate any deal that is not basically in the ballpark of what I am looking for. GRM is very effective in this role because it can be done on a napkin at a restaurant. All you need is the gross rent and the listing price. The only time it gets more complicated than this is when you have to project rents, in which case you may need a little more information on the unit mix and market rents. GRM also helps to prevent frustration on the part of the real estate agents finding you deals. If an agent knows your GRM cut off is 8, they know not to waste your time or their time bringing you any deals above 8.

If the property passes the GRM filter, then I calculate the cap rate to see if it meets my criteria. If so, I begin digging into the vacancy factor and the operating expenses to determine whether the NOI used to calculate the cap rate is realistic. A little trick to quickly determine where to get started on your analysis is to look at whether the operating expenses are significantly less than 35% of the gross rent. If so, either the building is unusually efficient or somebody is playing with the numbers.

Using GRM and cap rate together helps you to catch inappropriately stated operating expenses because the more a listing agent or seller artificially lowers operating expenses the greater the gap between the GRM and the cap rate. GRM is not affected by operating expenses. So, if the gross rents stay the same and expenses are lowered, then the GRM stays the same and the cap rate increases.

Agents or sellers that understate the operating expenses will often only post a cap rate on their listings to make the building look more attractive. By using this two-step filtration process, you will catch this. Your job is to make sure that no matter how the data comes to you, you are able to make a sound decision about whether to move forward on a particular property.

Notes:

CHAPTER 3
FINDING DEALS

There is no good or bad time to invest in real estate. There is only a good or bad strategy. Deals can be found in every market and every part of the market cycle. For the most part, what separates successful investors from everyone else is persistence. If you are prepared to make 100 offers for every 1 you get accepted, you will do well in this business. If you are disappointed and discouraged every time you miss out on a deal, you will not. This is another way of saying never fall in love with a property; it's a numbers game.

I can't tell you how many times I have heard an aspiring new investor tell me he or she has found the deal of the century. "You don't understand. This deal is incredible! No really, this deal is truly unique." There is no such thing as the deal of the century. There are deals that make you money and deals that don't. Attachment to a particular deal not only leads to disappointment, it causes you to make imprudent decisions in order to make the deal happen. It causes you to expend inordinate amounts of time chasing the deal and in that time you could have found two more. The tendency to become attached to a particular property is typically a function of having too few properties on your radar. Scarcity of prospective properties, in turn, is the result of not having a systematic approach to finding new deals.

Many books on real estate investing approach the topic of deal finding by simply providing a shopping list of commonly cited approaches to sourcing new deals—multiple listing services, driving neighborhoods, auctions, flyers, etc. The problem is that they offer no way of prioritizing truly productive strategies and weeding out marginal strategies.

Only a targeted, well-executed approach to tracking properties will yield consistent results. We will not, therefore, cover every strategy ever tried. We will, instead, cover the strategies that have a solid track record of producing deals consistently. Any one of these strategies can usher you to financial independence. Pick one and perfect it.

The Strategy Grid

The best way to think about deal finding strategies is to categorize them according to the posture of the property owner. It is important to remember that not every owner that might be willing to sell has made the conscious decision to sell. We must distinguish between owners and sellers.

- **A Motivated Owner** is an owner that has not made the conscious decision to sell but has a compelling reason to sell the property in question at a discounted price or be receptive to a proposal of some kind. Since the owner has not made the decision to sell, if you can reach such an owner, you have no competition at the negotiating table. This category of deals tends to yield the greatest profits.

- **A Motivated Seller** is simply a motivated owner that has decided to list the property for sale. The act of listing the property either privately or with an agent invites competition for the property and therefore reduces the profits. The success of a strategy that targets motivated sellers turns on the speed with which you get to the seller once they have made public their intention to sell.

- **An Involuntary Sale by Owner** is a transaction where the property is being sold against the will of the owner as in the case of a foreclosure sale. Many investors assume that involuntary sales necessarily equate to discounted pricing. Not true. Involuntary sales can sometimes lead to good deals, but there are a number of factors that affect the level of discount.

- **A Voluntary Sale by a Non-Motivated Seller** is what we think of as a traditional sale. There is little opportunity for striking a deal under these circumstances and, as such, we will not spend much time on this type of sale in this chapter. Such a sale only becomes attractive if at some point the seller's circumstances change such that the deal falls into one of the other categories.

These categories give us what I call the Strategy Grid below. This is the grid that we can now use to map out our plan for acquiring deals.

STRATEGY GRID		
	Owner	**Seller**
Motivation	**Motivated Owner** (No Competition) • Referrals • Direct Contact	**Motivated Seller** (Competition) • MLS Fixers • REOs • FSBO's
Choice	**Involuntary Sale By Owner** (Competition) • Foreclosure Auction • Partition Sale • Property Tax Lien Sale	**Voluntary Sale by Non-Motivated Seller** (Max Competition) • MLS Normal

HUMANITY CHECK

KEEP IN MIND THAT IN MANY INSTANCES WHAT WILL BE AN OPPORTUNITY FOR YOU CONSTITUTES A LOSS FOR SOMEONE ELSE. THE LOSS OF A PROPERTY CAN BE A TRAUMATIC EVENT. BEAR THAT IN MIND AS YOU EMBARK IN THIS BUSINESS.

- DO THE RIGHT THING AND MAKE SURE THE PROPERTY OWNER FULLY UNDERSTANDS WHAT THEY ARE AGREEING TO

- WHERE POSSIBLE HELP PEOPLE MOVE ON WITH THEIR LIVES WITH DIGNITY.

The Motivated Owner

Why would someone sell a property that wasn't listed for sale? The typical Motivated Owner is property rich and cash poor. As a result, they are not able to maximize the property's potential because they don't have the financial resources to adequately address issues that may have arisen at the property. The tendency, therefore, is to engage in a series of Band-Aid fixes that plug holes and stop gaps but leave the core issue unresolved (e.g., main line that repeatedly backs up because the pipes are too old and need to be replaced). These recurrent problems act as both a financial and a psychological burden. Marketing a property for sale requires a conscious decision to part with the property. Many owners know that economically they need to sell but struggle emotionally with the thought of losing the property. The property may have been in the family for a long time, or it was the first property they ever acquired, or it used to be very profitable and the owner hasn't fully come to terms with the fact that it is no longer the prized possession that it used to be, or it could just be simple procrastination—the owner just hasn't gotten around to putting it on the market. Your goal is to convert a Motivated Owner into a seller.

Perfect example is a property that I am renovating even as I am writing this chapter. The property was not on the market for sale, it was owned by a trust where the nephew of the trustee in charge of the trust was living in the property. The nephew was under the influence of drugs or alcohol or both every time I saw the property regardless of the time of day. My Money Partner refused to return to the property after the first visit because the nephew confronted him in a way that was very threatening. Who wouldn't want to be rid of a nephew like this, right?

But prior to being approached, it had not occurred to the trustee that selling the property meant bye-bye to the nephew. In fact the trustee told us that her primary motivation for agreeing to sell the property was so that she wouldn't have the guilt of knowing that she was enabling her nephew to destroy his life. For this reason, she really didn't care about whether she got full market value or not she just wanted him out of the property.

STRATEGY HIGHLIGHT

Why Motivated Owner Deals Yield Such High Returns

1. There are no competitive bids to drive up the price.
2. The owner has not fixated on a particular price point and therefore is more open to suggestion.
3. The owner is more open to creative solutions that minimize your capital outlay and increase your cash on cash return.

So how do you reach someone who might be motivated to sell but doesn't have the property listed? The primary ways to reach the Motivated Owner are:

1. Referrals from third party professionals
2. Direct contact through marketing strategies

Referrals

A consistent strategy for finding out about owners that might have a reason to sell if presented with the right offer is by referral from property managers, real estate agents or birddogs. Owners in trouble will often confide in and confer with the real estate professionals that are most closely associated with the property, like the real estate agent that sold them the property or the property manager that is currently managing the property.

There is a misconception in the real estate industry that you cannot get anyone to do anything without a referral fee and, therefore, the only way to get such referrals is by offering a referral fee. Although there are circumstances where it makes sense to pay a referral fee, there are two reasons why it is problematic to believe that this is the only way to get referrals:

1. In many situations a referral fee is prohibited because it incentivizes professionals to breach fiduciary duties to their clients; so, to the extent you plan to offer a referral fee for a referral make sure that it is legal in your area.

2. More importantly, if a true professional stands to benefit financially from working with you, the additional incentive of a referral fee is unnecessary and can sometimes demean you in the eyes of such a person. What you want to establish are long-term business relationships predicated on mutual benefit and respect.

Property managers almost always know when their clients are hurting for cash because they are familiar with the repairs that the property needs that the owner is unable to afford. In addition, owners will often share their frustration with property managers as they struggle to find a way to cope with mounting financial difficulties. Keep in mind that property managers have a fiduciary duty not to reveal information that adversely affects the interests of their clients. This duty, however, does not prevent property managers from notifying their clients that there might be someone interested in either acquiring their building or infusing capital into their building in exchange for an equity stake. The

more relationships you forge with property managers, the more likely you are to find out about prospective properties.

Why would a property manager be willing to work with you? Well, let's consider for a moment how property management companies make money.

- They collect leasing fees every time units rent.
- They collect a percentage of the gross rent of the building.
- They collect service fees for work done on the property.

Assume that a 20 unit building is half vacant because the owner doesn't have the money to renovate and lease the units. An infusion of capital into this building that results in the filling of the vacant units literally doubles the property management company's revenue. This is a very compelling reason to help the owner find a solution to his or her financial difficulties. To the extent you represent such a solution, you will be well received. Fortunately, property management companies are easy to reach both onsite and at their home office.

The motivation for real estate agents to help distressed owners sell their properties is relatively obvious. If you are not represented by your own agent, they will immediately realize that they have the opportunity to make the commission for both sides of the transaction.

This doesn't necessarily mean that agents will proactively call potential sellers on your behalf. It does mean that if they get wind of a potential deal, you stand a chance of getting the call first. In this business, half the battle is getting the call first. When you do get the call, you must be in a position to deliver or you will burn the relationship and damage your reputation in the market.

A third, and extremely effective, way to get referrals is from birddogs. Birddogs are typically unlicensed real estate professionals who focus solely on hunting down deals, getting them under contract and then assigning the contract for a fee. The fee may range greatly depending on the purchase price and the discount off fair market value. Like any other specialist they develop over time their own proprietary ways of

tracking deals that they may or may not share with you. Your primary concern is that the deals are solid and fit your parameters.

Because birddogs typically have the property under contract when they call, they typically have a very short time within which they need you to make a decision on whether you will accept the property or not. This means they will be heavily biased in favor of investors who make decisions fast and close and when they say they are going to close. It is important, therefore, that you take the time when establishing a relationship with a birddog to be as specific as possible about what deals you will accept. That way you only spend time looking at deals that meet your criteria and you don't find yourself repeatedly rejecting what the birddog brings you.

The easiest way to ensure that your parameters are clear to people who might refer you deal is to have a parameter sheet that you can email. A parameters sheet includes information such as:

- Price Range
- Age Range
- Bed/Bath count
- Zip Codes/Cities
- Condition (Poor, Fair, Good, Excellent)
- Discount Percentage

Keep in mind that until you have been in the business for a while, it is difficult to build your business entirely around referrals. Referrals will be one of several methods that you will need to employ. But given the profitability of this type of deal, the effort is well worth it. You also cannot assume that even the best-intentioned property manager, real estate agent or birddog will make you their number one priority. You must be proactive about regularly pinging them to make sure you are at the forefront of their mind when an opportunity presents itself. As you close deals, you will move up their priority list quickly.

TIP

A recent proof of funds statement (e.g., bank statement) and pre-approval letter from a lender that demonstrates your ability to actually close on a deal will go further than a referral fee.

Direct Contact

Another effective way to source Motivated Owner deals is to market directly to the owners. Apartment Owner's associations, mobile home owner's associations, and similar groups all have websites and publications that are subscribed to by owners in the industry. These resources are not fluff. They provide valuable information and are regularly read by property owners. A well-crafted ad in the appropriate publication will get the attention of an owner in need of help. I recently sent out an email blast to mobile home park owners and received 26 calls the first day, which resulted in three significant contracts.

Simply sending a letter to the property owner stating your proposal is another way to reach the owner directly. In fact, one of the most profitable apartment buildings I ever acquired resulted from just this approach. Here is what happened. I acquired a ten unit building in Los Angeles significantly below market. After several trips to the property, I noticed that the building next door had the same number of units in the same configuration except that my building was five, one bedroom's and five, two bedrooms and the building next door was ten, two bedrooms. Unlike my building, however, the building next door was clearly in disrepair even though the units were all occupied. It occurred to me that it would be nice to own both buildings and have one onsite manager manage both. So I pulled a title report on the property, found the mailing address of the owner and sent the following very simple letter.

> "Dear Mr. Smith,
> I recently acquired the property located at 123 Main Street. This property is next to your property located at 456 Main Street. I acquired 123 Main Street for $________ and would like to know if you would be interested in selling your building for the same price. If you are interested in entertaining an offer, please call me at 310-555-2233. Thank you in advance for your consideration."

After several rounds of negotiation, I was able to acquire the property for the same price because I wasn't being represented by an agent and therefore the owner was able to save commission costs. As you can see from this example, a title report can be a very valuable tool. A title

report is a report from a title company that summarizes the title information about the property such as:

- The legal owner of record
- Outstanding liens against the property
- Whether property taxes are current or delinquent

It is important to establish a good working relationship with a title officer that has experience working with investors

STRATEGY HIGHLIGHT

Structure of Letter to Motivated Owners

The content of the letter will depend on what you are targeting and what you are offering, but if you adhere to the following guidelines your chances of succeeding will improve dramatically:

- Keep the message simple and short—nobody is going to spend a lot of time trying to figure out who you are and why you are contacting them.

- If you are making several key points, use bullet points to draw the owners eyes to that part of the letter in case they are not inclined to read the whole thing.

- Focus on what's in it for them and get to it quickly. Do not spend a lot of time introducing yourself.

How do you know which owners to attempt to contact? Prosperity tends to manifest itself in the form of well-maintained properties. Conversely, financial adversity reveals itself in the form of poorly maintained properties. Think of yourself as a private detective trying to find a person with clearly defined characteristics. In this case, those characteristics are signs of financial distress. Driving neighborhoods looking for overgrown lawns and overflowing mailboxes, however, is an inefficient use of your time.

On the other hand, certain professionals, regularly drive through neighborhoods as part of their daily routine such as:

- Landscaping companies
- Pool servicing companies
- Pest control companies
- Postal workers
- Pizza delivery drivers
- Cab drivers

The driver for a landscaping company will not necessarily know the owner of the property with the overgrown lawn because, clearly, the owner is not using a landscaping company to maintain the lawn. The driver can however get the address of the property with the overgrown lawn to enable you to make direct contact with the owner.

A more broad-reaching and systematic version of the same approach is a mailer campaign. For a fee, data companies will assemble the names and addresses of owners with properties that fit specified parameters. Mailer campaigns require unrelenting consistency to succeed because statistics show that the average person must see the mailer 4-6 times before they even consider responding. This response rate will certainly vary depending on how compelling the message is but you should not be discouraged because you don't receive responses immediately.

Sometimes it is not the message, it is the presentation. An enclosed letter versus a postcard makes a difference depending on your target. Marketing companies that specialize in direct mail campaigns can be a tremendous resource in this regard. Of course, their services will come

with a fee but that fee will prove insignificant if you succeed in closing a transaction.

STRATEGY HIGHLIGHT

Profiting from Code Violations

An extremely rich source of data for your mailer campaigns is the building code enforcement department. Most cities have a department that is responsible from ensuring that rental units meet certain standards of habitability. Depending on the city, inspections by this department are:

1. Conducted annually
2. Conducted when a complaint is filed
3. Conducted as a prerequisite to the sale of the property

If the property is found not to be habitable (e.g., rodent infestation, mold) or found to be in violation of building code requirements (e.g., inoperable windows, ungrounded electrical outlets), the building will be cited. Citation penalties can range from a fine to total confiscation of rents to emptying the building.

Needless to say, an owner that has been cited by the city but doesn't have the resources to comply, is in a world of pain. Buildings with code violations are often a matter of public record and this data can easily be compiled into a mailer campaign.

The Motivated Seller

Although the decision to sell announces the availability of the property to the investor community and invites competition, there are nevertheless powerful strategies to find deals even amongst listed properties. In order to understand these strategies, however, we must first understand how to use the most common tool for listing properties, the Multiple Listing Service (MLS) and other listing websites intended for commercial properties.

An MLS is a database that allows real estate brokers who have been retained by sellers to market their listings to brokers who are representing buyers. MLS services are restricted to real estate brokers but unfortunately most brokers do not have a lot of experience working with investors. They do not know how to comb through the thousands and thousands of listings to find the diamond in the rough. Therefore, you must either get a real estate license and get access directly or guide the person who does have access.

Modern MLS software is a sophisticated research tool if used to its full potential. It provides a significant amount of information about the property that can provide clues about what's going on with the owner and why they are selling.

Change of Status Search

When wading through thousands of listings you need criteria that will allow you to narrow your search. One of the most effective criteria is "change of status." Most MLS software allows you to filter your search such that you pull up only properties where there has been a change in the status of the listing in a prescribed number of days. If you focus strictly on properties, for example, where there has been a price drop in the last two days, the number of properties you will be considering is reduced dramatically.

What is important about a recent, significant price drop is that it tells you something has changed in the seller's thinking. A change of status search catches sellers at the very moment that reality has set in upon them. The size of the drop tells you how motivated they are to unload what they now realize was an overpriced property. Keep in mind that some price drops merely reflect a lowering of the property to a more realistic market value. What you are looking for is the liquidation drop. A price drop that says, "I need to get rid of this property now!" You are looking for a price drop that lowers a property that was already 10% below market to 20-30% below market in a single change.

You don't want the seller that is lowering the property 5% every 30 days. Small incremental drops like this indicate a seller that is not motivated at all but rather attempting to get the maximum market value by reducing the price just enough to hit the true market value without going below market value.

TIP

Check for status changes late at night or early in the morning so that you can get your offer in first.

Comment Search

Another powerful way to hone in on deals with potential is to search by comment. Agents have relatively consistent ways of describing good opportunities. Once you know their language you can focus on identifying deals that have potential. Below are some common agent comments and their strategic significance.

Agent Comment	Translation
"TLC"	Property needs cosmetic repairs and is not market ready.
"Fixer"	Necessary repairs could range from light cosmetic to heavy. Hint: The fewer the number of pictures, the more work the property probably needs.
"Bring your investors"	Heavier rehab that might involve fire damage, structural problems, or other issues that involve more experience.
"Must Sell"	Typically this comment will accompany other motivational words like "divorce", "relocated", or "already purchased new home". If there are no other motivational reasons it could just be a marketing ploy.

This, of course, is not an exhaustive list because there are an infinite number of ways to express the comments above but it gives you the type of comment you are looking for. Many MLS systems allow you to search by comment.

Generally speaking you want to avoid properties where it appears that the seller has spent a significant amount of money renovating the property, like "newly remodeled kitchen".   Sellers that are heavily invested in a property have a more difficult time cutting their losses. Essentially you end up paying an emotional premium. This tends to be true even if the comment says "motivated seller". In fact, what you really want is the seller that knows that they have not done an adequate job maintaining the property or making it market ready in which case you get the guilt discount.

Emotional Premium	Guilt Discount
"Newly Remodeled Kitchen"	"Great floor plan"
"Prize-winning rose garden"	"Spacious yard"
"Wonderful hardwood floors"	"Good bones" (i.e., structurally solid)

Foreclosure Notices

Prior to foreclosing, banks must file notices at the county recorder's office putting the property owner as well as the public on notice of their intention to exercise their right to force the sale of the property in response to a default on the mortgage. Depending on where you live or are looking for properties, the process will differ. If you are in a province that allows for a non-judicial foreclosure, the lender can compel the sale of the property simply by filing the requisite notices (e.g., notice of default, notice of sale). Some provinces require that the lender get an order from a court to sell the property, known as a judicial sale. In these provinces the lender typically will file a lis *pendens* on the property, which literally means litigation pending. A *lis pendens* acts as a cloud on the title. For many property owners, the filing of these notices serves as a wake up call. All of sudden the possibility of losing the property becomes real and the erosion of options becomes apparent.

Owners in this situation who do not have the financial resources to bring the loan current and do not qualify for a loan modification have only two remaining choices: (1) let the property go to sale, or (2) attempt to sell the property before it goes to sale.

Owners recognize that if their property goes to public auction the likely bidders will be real estate investors who will acquire the property at a discount. This discounted price will wipe out a significant portion of their equity to the extent they have any equity left in the property. Equity is the difference between what is owned against the property and the fair market value. For this reason, option one, let the property go to sale, is generally a bad option for the owner if the property has equity. The owner is better off attempting to sell the property prior to public auction. In this situation, the seller is motivated by the fact that they must consummate the sale prior to the auction date. Knowing

whether notices have been filed against a property is an important piece of information to have when making an offer and this information can be obtained from local title companies.

If the property has no equity, the sale of the property prior to the foreclosure date will force the lender to take a loss so the owner must receive the lender's permission. This is known as a "short sale". Short sales only prove profitable for investors if the lender is either misinformed about property values in the market or the lender consciously decides to allow an underpriced sale in order to get the property off their balance sheets.

STRATEGY HIGHLIGHT

Getting the Jump

Contacting the property owner upon the recording of the Notice of Default (NOD) but prior to their decision to list the property for sale would constitute a Motivated Owner approach. Many investors attempt to get to the owner during this phase to get a jump on the opportunity.

Although this can be effective in certain circumstances, keep in mind the following:

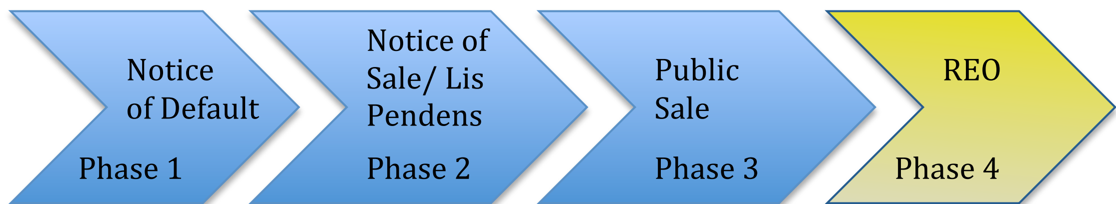
- Many owners don't even realize that an NOD has been filed against their property and will be both alarmed and annoyed by being approached by an investor based upon information they did not realize was even public.

- Many owners early in the foreclosure process have not emotionally come to terms with the fact that they are losing their property. Your attempt to acquire the property may be perceived as predatory and insulting. In fact, as a result of the unscrupulous actions of investors in the past, some states require special forms to be used when an offer is being made on a property that is already in the foreclosure process.

Recognizing the sensitivity of such situations will go a long way towards allowing you to have a productive negotiation with the owner.

REO's

Much ado has been made about Real Estate Owned (REO) by banks. Some of the buzz is justified; much is not. REO's represent the last stage of the foreclosure process after the bank has compelled the public auction of the property and been forced to take the property back into inventory as a result of not receiving an adequate bid at the auction.



The likelihood of acquiring REO's from banks at significant discounts depends greatly on where in the housing crisis cycle you catch the banks. Typically at the beginning of a housing crisis, banks are inundated by REO's and don't have the internal structure in place to deal with them effectively. As a result, the inclination is to simply dispose of them quickly without much regard to achieving maximum sales price.

As you get deeper into a housing crisis, banks begin to retain appraisers to more accurately assess the value of the property, they begin to work with contractors to renovate the property and get it into a more marketable condition, and they push back on real estate agents trying to push through a quick sale. In this phase, REO deals get harder to find and the margins trim down. This doesn't mean deals can't be found. But it does mean that the blanket assumption that REO equals good deal won't bear out. You will need to scrutinize these deals as you would any other and be patient with your offers because it could take anywhere from several days to several weeks to get a response.

Working with real estate agents who have been in the REO arena for at least one full market cycle (i.e., 10-15 years) can be very beneficial. They typically have relationships with several lenders and can tell you exactly what you can expect in the way of a discount or lack thereof. They can also guide you with respect to how to submit your offer in a way that will ensure it gets serious consideration. Most importantly, they often know what's coming down the pipeline. Some banks will

consider offers strictly in the order they are received, so getting your offer in early is especially important.

Great deals can be found by keeping a close watch on what's happening in the REO market.

TIP

Banks often make a policy decision to write off losses and liquidate REO's at significant discount just to clear their balance sheets. If you are able to capitalize on these opportunities, you will do extremely well.

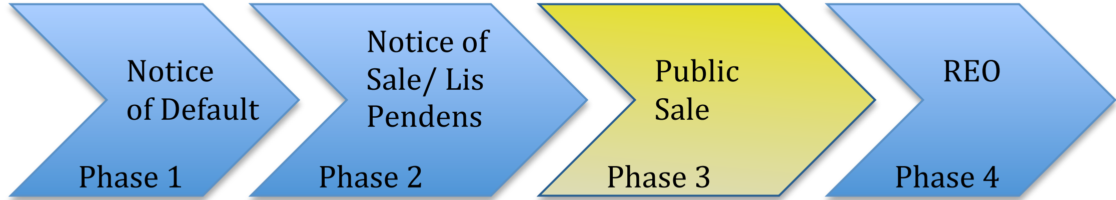
FSBO

A property listed For Sale By Owner (FSBO) means that the property is not listed by a broker on an MLS. Instead, it is being marketed by the seller directly. Prior to the explosion of the internet, this typically meant advertising the property in a local newspaper and putting a sign on the lawn. Now it could mean any number of sites where sellers can post their properties directly. In fact, as one might expect, there are websites dedicated entirely to listing properties nationwide that are being sold directly by the seller.

Note that FSBO does not necessarily mean distressed or motivated seller. It could simply mean that the seller does not want to pay the costs associated with being represented by a real estate agent and is comfortable enough with the documents associated with the sale of property to handle the transaction alone. Keep in mind that to the extent you are also not being represented by an agent, those commission savings can be used to reduce the price. One advantage of tracking FSBO's is that FSBO's give you direct access to the seller, which in many instances can allow you to be much more creative in structuring your deals.

Involuntary Sale By Owner

The category of involuntary sales is overwhelmingly dominated by foreclosure sales so let's review the foreclosure process.



The foreclosure strategy means acquiring the property at the actual public sale. Properties go to sale for a variety of reasons including:

- Owner couldn't sell the property in time
- Owner wasn't able to bring the loan current in time
- Owner is in denial
- Owner attempted to get a loan modification and ran out of time

The point of the sale is to repay the obligation owed to the foreclosing lender. This lender, therefore, will typically enter a bid equal to the loan amount plus legal fees, late fees, etc. If nobody bids higher than this amount the lender will reclaim the property as an REO. If somebody bids higher than the lender's bid, the lender will get paid off and the difference will go to the old owner. The purchaser at the sale will own the property free of any subordinate liens (i.e., 2nd mortgages) but subject to any superior mortgages (i.e., property tax liens).

For the most part at a foreclosure sale you will be competing primarily against other investors because the winning bidder must pay all cash for the property at the conclusion of the sale. Most people buying a home as a primary residence are not in a position to pay all cash for the property. To the extent there is a bidder at the auction interested in living in the property that bidder will almost always outbid the investors who are looking for a substantial discount.

A live auction can be an exhilarating experience. The danger is that the excitement of the moment can cause you to bid more than you originally

anticipated. Since you don't know whether the next bid will be the winning be, the temptation is to say, "Just one more". This is an extraordinarily dangerous mindset.

You must go into the auction knowing what you are willing to pay for the property based upon your research and stick to that figure. The most valuable asset you can have at a foreclosure sale is a level head.

Bear in mind that most of the foreclosure sales you track will end up getting postponed for one reason or another and only a small percentage will end up actually going to sale.

STRATEGY HIGHLIGHT

Drop Bids

An extremely powerful strategy for achieving deep discounts at foreclosures sales is by tracking drop bids. An auction begins with an opening bid. The opening bid is generally the outstanding balance of the foreclosing loan plus the fees associated with it. In many cases, investors disregard a property because the opening bid is too high. As a result, the property essentially falls off the investor radar.

For internal reasons, lenders will occasionally reduce the opening bids on the day of the sale. These bid reductions will convert an unprofitable deal to a profitable deal. This information will typically not be reflected on the websites that track foreclosures until within hours or even minutes before the sale. If you are continually checking for drop bids you may find that you are the only person bidding on a property! The other person that has access to drop bid information is the auctioneer. So a good relationship with the auctioneers is vital. Tracking this information gives you a significant competitive advantage in a highly competitive environment.

Other Involuntary Sales: Partition and Property Taxes

Foreclosure sales are not the only auctions where property is sold against the will of the owner. Whenever property is sold at auction there is an opportunity to acquire the property at a significant discount. One such example is a partition sale. A partition sale is a court ordered sale for the purpose of liquidating a property owned jointly by parties interested in going their separate ways. For example, let's assume a general partnership with two partners owns a four unit building. Partner A decides he no longer wants to be a partner but Partner B does not have the resources to buy him out. Partner A can go to court and request to have the property sold in order to be liquidated from the partnership. The resulting sale is a partition sale. One of the more profitable properties I bought in my early career was a duplex at a partition sale. A partition sale can also result from a bankruptcy proceeding.

Another common involuntary sale is a property tax lien sale. When property taxes are delinquent a lien is placed upon the property and the property can be sold to satisfy the lien. Generally, the amount of the lien is small relative to the value of the property but the property is hardly ever sold for the amount of the lien because bidders at the auction will bid up the property. As with any other strategy, success depends on consistency and persistence.

STRATEGY GRID		
	Owner	**Seller**
Motivation	**Motivated Owner (MO)** (No Competition) • Referrals • Direct Contact	**Motivated Seller (MS)** (Competition) • MLS Fixers • REOs • FSBO’s
Choice	**Involuntary Sale By Owner (ISBO)** (Competition) • Foreclosure Auction • Bankruptcy	~~**Voluntary Sale by Non-Motivated Seller** (Max Competition) • MLS Normal~~

Plan of Attack

Step 1. Pick one strategy from each of the three approved categories: Motivated Owner (MO), Motivated Seller (MS), Involuntary Sale By Owner (ISBO).

Example:

- **MO: Direct Contact**
- **MS: MLS Fixers**
- **ISBO: Foreclosure Auctions**

Step 3. Rank your strategies first, second and third.

Example:

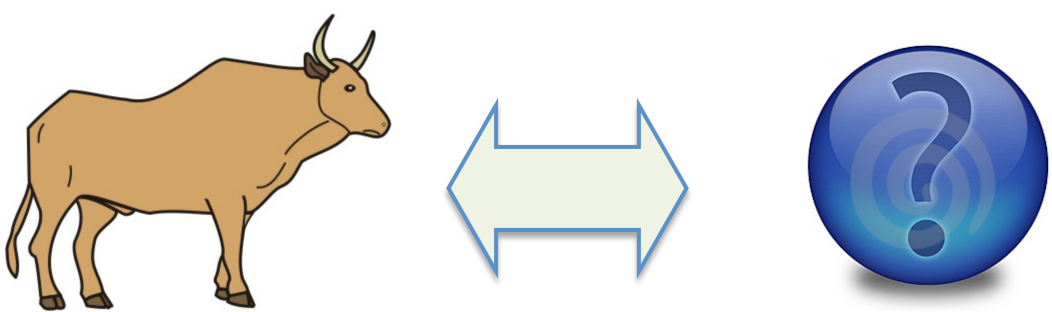
First—MS: MLS Fixers
Second—ISBO: Foreclosure Auctions
Third—MO: Direct Contact

Step 3. Divide your week so that you spend three days on your first strategy, two days on your second strategy, one day on your third strategy.

REMEMBER: Persistence Pays

Notes:

CHAPTER 4
BARTERING: THE ART OF DEAL MAKING



Once you find a deal, you must know how to strike a deal. So before we discuss how to actually write up an offer we need to discuss the art of deal making. Before the Civil War, Andrew Carnegie, considered the second richest man in history, made his first profitable deal by arranging a merger between T.T. Woodruff, owner of a sleeping car company and George M. Pullman, the inventor of a sleeping car for first-class travel which facilitated business travel at distances over 500 miles. Carnegie received an interest in the deal for bringing the two people together and this transaction helped launch his career.

In the history of commerce, paper currency (dollar bills) is a relatively new phenomenon. For thousands of years before money as we know it today existed, people traded goods that they had in abundance for either services or goods that other people had in abundance. This practice is called bartering and with the advent of money, bartering was marginalized to less advanced civilizations, or so we are led to believe by contemporary economics textbooks.

But is it really the case that we no longer barter? When Judy says to Karen can you take my shift tonight at the grocery store and I will cover your shift next week, are they not bartering? When Doug says to his buddy Phillip, how about if you help me set up my new entertainment unit and I'll buy you a beer, Phillip is exchanging his physical energy not for the money that was used to buy the beer, but for the beer itself.

Lest you leap to the conclusion from these examples “yeah, but that’s just silly stuff and it’s really just friends helping each other out,” let me give you another example from the world of small business. Every Wednesday at 7:30 a.m. you attend a networking group that encourages everyone in the group to refer business to everyone else in the group. In fact, they actually track who is making a good faith effort to refer business and who is not. If you are remiss in doing your fair share of referring, you run the risk of having your membership revoked. Pure bartering.

I know, you’re thinking “but that still is not “real” deal making”, that’s just some professionals trying to get their business off the ground. On the contrary, billions of dollars of business gets done through networking groups like this. But I understand, it still lacks the feeling of a firm handshake and wire instructions. How about this one? Apple Inc., a billion dollar company, gives AT&T, a billion dollar company, the right to be the exclusive wireless network for their highly anticipated iPhone in exchange for gaining access to AT&T’s extensive network of customers and coverage. Apple had no reputation in the cell phone industry but the iPod was making the Apple brand synonymous with cutting edge contemporary. AT&T was struggling to maintain market share in the face of Verizon’s relentless and highly successful “Can you hear me now?” campaign. The trade: Apple gets credibility as a cell phone provider; AT&T gets cool points.

You can structure deals exactly the same way. But you must first liberate your mind from the notion that money is the only tool you have to acquire things. Not everything that people want can be quantified and purchased with money. And if you don’t give people what they want, they will not give you what you want. On the other hand, if you understand how to give people what they want, your ability to structure deals will no longer be tied to how much money you have to work with. Carnegie brought two people together who wanted to combine their businesses and launched one of the most profitable careers in history. Your ability to generate wealth will increase exponentially if you understand the power of bartering.

Valuables are more Valuable

What makes bartering so powerful as a wealth creation tool is that anything of value that you can think of can be bartered. We assign value basically to anything that is desirable. We will refer to these things as "Valuables". I divide Valuables into four categories, which I call the Valuables Matrix:

Peace Inner Peace or Spirituality Outer Peace (Lack of Stress)	**Love** Family Relationships Intimate Relationships Deep Friendships
Happiness Fun (laughs, sports, hobbies, sex) Material Possessions (clothes, cars) Food	**Health** Mental Health Physical Health

We cannot survive as human beings without these Valuables in our lives, and we are impoverished in direct relation to their absence. Our survival instinct will take over when we are dangerously depleted of these Valuables and replenishing them will take precedence over all other considerations.

Notice that one item is conspicuously missing from this list—money. Why? Because money in and of itself is not valuable. Money is nothing more than a gift card. What! A gift card!?

Okay, it's the holidays and you are walking up and down an excessively crowded mall trying to figure out what to buy your sister. You are not

really sure what she wants. So what do you do? You get her a gift card to a store that she likes. The gift card itself is not valuable to her. If for some reason the store stopped honoring gift cards, she would throw it away. It is only valuable to the extent she can use it to buy a dress for example or something else of value.

Money is only a means of acquiring a Valuable. The only reason we exchange money is because (1) it's convenient (2) we don't know each other well enough or (3) we are lazy. If it is your wife's birthday and you know that Chanel No. 5 is her favorite perfume and she just ran out, would you go to the store and buy her Chanel No. 5 or would you simply stick money in an envelope and put it on the dresser (keeping in mind that money in an envelope equals sleeping on couch)?

Real estate is no different. If I know what you want, I don't need money. Might a property owner give you an interest in his building if you can help him reduce his stress and spend more time with his family? Absolutely. Is that a fair trade? Absolutely. Do you necessarily need dollar bills to make that trade? Absolutely not. We live in such a money-oriented society that we think that everybody always wants money.

TIP

People never really want money. They want Valuables.

Your job is to get good at figuring out what people *really* want and help them get it. In exchange, they will give you want you want. Keep in mind that what you really want ultimately is not money, it is also Valuables.

Time is Money - Or is it?: The Hierarchy of Currencies

If you look back at the Valuables Matrix you will notice that another important item is curiously absent—time. Not only is this not an accident, it is part of the point of the matrix. The Valuables Matrix does not include things that are a means to an end; it only includes the end. Time is a means to an end. We have all heard the expression time is money. Have you ever stopped and thought about what is meant by that expression?

Even though time stretches on century after century, our individual lives are finite. We only have so much time on this planet. The finite nature of our lives gives time meaning and value. It is the reason, for example, we say don't "waste time." You couldn't really waste time if you had an infinite amount of time at your disposal.

But time, in itself, is not a Valuable. We value time because it allows us access to a Valuable. If we don't have to get that project done at work, we have more time to *spend* with our family. It is not a linguistic accident that we use the word "spend" when referring to time. What is the other thing that we "spend"? Money.

What we are really saying when we say time is money is that like money time is also a currency that can be spent on Valuables. Except, they are not equal. Time is more powerful, because time can buy you more Valuables than money. You can only acquire deep friendships if you *invest* time into the relationship. You cannot buy a deep friendship with money no matter how much money you invest. Inner peace requires time to reflect, meditate, or pray. Because we do not live forever, we cannot get more time. If we lose money, we can get more. If we lose time, we cannot get it back.

TIP

Time is currency like money but it is a much more powerful currency because you cannot print more time.

A Little Story About Time

Once upon a time, early in my career, I was approached by a commercial real estate broker who had a 16 unit building for sale in Los Angeles. By any measure, the building was at least $200,000 below market. As I always do when I inspect a building, I asked to speak to the tenants because tenants can't wait to tell you everything that is wrong with the building. I picked a random unit on the first level. In speaking to the tenant, she warned me about the building as tenants so often will, but her admonition was a little unusual. Here is what the tenant told me:

> Tenant: "Folks in this building are spoiled so you might have a problem young man."
> Me: "Spoiled how?"
> Tenant: "The owner of this building shows up once a month on a different day each month at a different time of day to collect rent and whoever happens to be home when he shows up pays rent. Whoever ain't home gets a free ride that month."
> Me: "Are you serious?"
> Tenant: "As a heart attack."

Being slightly skeptical by nature, I insisted on speaking with the owner directly to understand what was really going on with this building. Here is what he said:

> Owner: "Well son," he chuckled "you see I have a 5th grade education so everything I have I got the hard way. I started buying apartment buildings 30 years ago and now I have 40 buildings all over Los Angeles.
> Me: "Wow! That's really impressive."
> Owner: "Yeah, but it's just me and my daughter managing all these buildings and I'm just plum tired. I am trying to just trade a few of these lower end buildings in for a few nice big buildings on the Westside and call it a day. I feel like all I do is go from one building to the next."
> Me: "If you own that many buildings you must realize that you are selling the building way below market" (yes I did actually say that)

Owner: "Of course, son, but I got more cash flow than I know what to do with. I'm glad to see someone young and hungry like you getting into the business. By the way, don't worry about all those vacant units. If you advertise at the hospital down the street you'll have those units full in no time. Nurses make great tenants."
Me: "I appreciate the advice sir."
Owner: "No problem. Good luck son."

It doesn't take a genius to figure out more money wasn't what he was after. He wanted more time to spend on whatever it was in his life that he deemed to be a Valuable. In short, he was exchanging his building for time.

The owner sold five buildings similarly below market. I bought two with money that I had raised from Money Partners. None of the properties had been listed on the open market; the seller did not even attempt to get competing offers. In other words, he was a Motivated Owner and I found out about the opportunity through a real estate agent that I had develop a good rapport with.

TIP

A person in need of rescuing isn't picky about the hero.

My guess is that by removing five buildings worth of responsibility from his life, his life was richer even if his net worth decreased slightly. As a side note:

Do you think someone who started with nothing and ended up owning 40 apartment buildings in Los Angeles knows something about how to negotiate? Yeah, I think so too.

Do you think maybe he acquired many of his buildings under the same circumstances and that's why he wasn't worried about letting a few of them go below market? Yeah, I think so too.

Do you think it is even possible that he acquired the buildings so long ago that he still made a killing? Yeah, I think so too.

TIP

Don't ever underestimate the person on the other side of the table. Just because you are getting a good deal doesn't mean the seller is stupid.

Motivators and Valuables

I refer to a source of significant motivation as a "Motivator". You must be an expert in recognizing Motivators if you are to be an expert at bartering. Here are some of the more common Motivators:

Stress Motivator:

Probate: Oldest sibling, Sue who lives in Cleveland, was recently appointed executor of mother's probate estate in Phoenix (meaning upon the death of her parent the will put her in charge of settling all of the parent's affairs including disposition of all assets). She is overwhelmed by all the responsibilities associated with administering an out-of-state probate estate. She feels like she is going crazy.

Fear Motivator:

Looming Lawsuit: Apartment building owner, Ted, has gang members in the building that are scaring the other tenants and spraying graffiti on the building itself. As a result, the building is half empty and the gang members are using the empty units for every variety of illicit activity. Ted is losing sleep at night over the thought that the gang members will eventually hurt a visitor or one of the other tenants, and he will held liable. He is concerned that his insurance won't cover him because he is aware of the risk and hasn't addressed it because he doesn't know how.

Emotional Pain Motivator:

Divorce: Wife, Mindy, files for divorce. She is a stay at home mom with two children and wants to sell the home as quickly as possible because it is filled with too many painful memories.

Anger Motivator:

Partition Sale: One business partner cuts a side deal and the other business partner, Greg, is so angry that he wants out of the partnership immediately and doesn't care about achieving maximum price.

If you think about each of these situations, yes it is true the seller typically (not always) expects some form of monetary compensation, but what they are really after is a Valuable.

When Stress is the Motivator, Health is often the Valuable:

Sue feels like she is going crazy. She wants her sanity back. She wants to feel like she is in control of her world again.

When Fear is the Motivator, often Peace is the Valuable:

Fear results from a perceived threat to safety. Ted is tired of getting calls from terrified tenants. He is tired of this violence being part of his life. He also feels threatened by the prospect of a lawsuit. A lawsuit is an act of aggression sometimes perfectly justified, sometimes not. That's why we *defend* against lawsuits. In fact, the entire field of Asset Protection is based on the notion of protecting yourself from harm. That's why martial and military metaphors like *fortress* and *bullet-proof* are so often used in Asset Protection literature.

When Emotional Pain is the Motivator, Love is the Valuable:

Mindy feels likes all the pain in her heart is preventing her from making room for a new relationship. She wants to move on and make room for love back in her life.

When Anger is the Motivator, Happiness is the Valuable:

Greg used to feel great about going into the office. Now he hates it. He wants to get back to building something that he feels good about.

In fact, for every motivator there is a corresponding Valuable that is being sought. Understand that a given Motivator might be satisfied by more than one Valuable and a given Valuable might satisfy more than one Motivator. The following grid provides example of how some Motivators and Valuables match up.

Motivator	**Valuable**
Stress	Peace
Fear	Health
Pain	Love
Anger	Happiness

Putting Theory Into Practice: Giving People What They Want

Before we discuss how we would actually structure the transaction from a legal perspective, we need to first examine how we would give each of the motivated owners/sellers above what they want? Let's look at them one by one.

Stress Motivator meets Health Valuable

What if you called Sue, the executor of the probate estate, and said,

> "I would like to purchase the house on ABC Street that's part of the estate you are in charge of".

First problem is that's obnoxious. Second problem is that you are not really giving her what she wants and she is likely to hang up the phone on you. She wants sanity, not money. What if you said to her:

> "I know that being responsible for a probate estate can be challenging. I work with several trash hauling companies that can help you dispose of personal effects you don't plan to keep. I also know a number of contractors who can help you renovate the property if you want to spruce it up before selling. If you need to sell quickly, I have investors who will purchase the property in its present condition so that you don't have to worry about finding the money to renovate it first."

The first offer is the kind of offer typical investors make. It is cold, insensitive and stupid. It is a money offer to someone looking for help. If you make this offer to Sue after completing my course I will hunt you down and confiscate all your materials. Please don't do this. The second offer is a Valuables offer. Nowhere in that offer did I offer to purchase anything. I offered her sanity and I will leave it to Sue to tell me what she wants to give me in return.

> Sue might decide, to say "I just need you to help me convince my siblings that we need to sell. I don't care what we sell it for. " (I

acquired a probate property significantly below market where the executor of the estate made precisely this request)

The barter: assistance with family politics plus some cash for a property significantly below market price.

Notice that in Sue's proposal she is also giving you control of the transaction. She is asking you to help the family understand what is a fair price. Fair does not mean full market price. Fair is that price that will enable you to achieve your objectives as an investor while at the same time enabling her to achieve her objectives as the executor of the estate. Do not assume Sue is naïve and doesn't understand you are an investor. She gets it. She understands the price needs to make sense for you as an investor. You need to be explicit about how you arrive at your number. The point is that she is open to an explanation of how you arrive at your number. This phenomenon of control shifting is extremely common in these situations because it takes a special kind of person to be a control freak and still admit they need help. However…

Voice of Conscience:
DO NOT TAKE ADVANTAGE OF PEOPLE WHO NEED HELP

Fear Motivator meets Peace Valuable

Hopefully, by now we know that we are not going to approach Ted and say "How much are you willing to sell your apartment building for?" Instead, we are going to ask ourselves what does Ted want to barter for. Ted wants to be rid of the gang members. So, our offer should include getting rid of the gangs and might sound more like this,

> "I am comfortable tackling challenging property management issues and I think with a combination of aggressive police intervention and a zero tolerance management style I can drive out the bad elements in your building and return the building to a positive cash flow property that we could both benefit from. I am familiar with the police lieutenant responsible for the precinct your building is in and am prepared to sit down with him and devise an action plan."

I have not offered to purchase the building because I might not want to be on title to this building given the liability exposure. I have simply offered a potential solution to Ted's nightmare. Let's say Ted responds by saying, "Well, what's in it for you." I would respond by saying "Why don't we share whatever cash flow I am able to restore 50/50. Does that sound fair?"

Of course its fair and Ted will agree its fair but what this translates to is a 50% stake in the building's entire cash flow because when you met Ted he was negatively cash flowing with a half empty building. It also translates to a perpetual annuity that you paid nothing for and did not need a credit score to obtain. Will it require some work on your part to turn the building around? Sure. But would you have to do that work anyway? Absolutely.

The barter: gang riddance action plan and no cash for 50% interest in the building's cash flow.

When Emotional Pain is the Motivator, Love is the Valuable:

Mindy is clearly not looking for maximum market value right now. What she wants is to burn the house down. You can't really give Mindy the love that she is looking for. She will have to find that on her own in time. What you can do is at least demonstrate to her that you care, keeping in mind that at this point she really doesn't trust anyone other than maybe her divorce lawyer. What I have seen in divorce cases like this where the stay-at-home mom insists on selling the house, is that she can't qualify to buy a new house because she has no credit profile. She and the children end up having to rent an apartment for years because divorce lawyers just aren't trained to think about things like this, and most divorce lawyers do not consult with a real estate professional prior to structuring a settlement.

So you might say to Mindy,

> "Maybe you should consider speaking with a mortgage broker to see what it will take for you to buy a new home once you have your settlement. I know several that I can refer you to. You can also go directly to the lender that you currently have a banking relationship with."

The barter: financial counseling plus some cash for significantly below market property.

If you give her a referral, do not refer her to someone because they are giving you a kick-back. Refer her to someone that will genuinely help her figure out what her next move will be. Mindy needs to know that someone cares about her.

When Anger Motivator meets Happiness Valuable
Greg just wants speed. By going to the court and demanding that the business property be sold, he is subjecting the property to a public auction, which is typically attended by investors. Investors will not pay market price for a property (unless they are inexperienced) and therefore Greg is destroying the equity that he and his partner have built. He doesn't care because he is miserable and wants out of the partnership, so you might say.

> "I know a good transactional lawyer that specializes in unraveling partnerships in a way that ensures that there is a clean break and you can move on."

What if you don't know a good transactional lawyer? Might it be worth it to find one in order to consummate the deal? Of course.

You might be asking yourself at this point how you discover what is really going on with the owner/seller. If it's a Motivated Owner, you are dealing directly with the owner, so typically you would have gotten the information from the person who referred you to the owner or you simply ask. If it's a Motivated Seller, you ask the broker. You would be surprised at what people disclose when they are given the opportunity. The problem is that most investors don't bother asking because they don't care.

TIP

It is profitable to care.

Notes:

CHAPTER 5
THE ART OF THE OFFER

Structuring an offer is an art form. It sets into a motion a dance between you and the seller that will either be smooth and graceful or jerky and contentious. The smoother the negotiation, the greater the likelihood that your offer will get accepted and your deal will get done. Admittedly, there will be circumstances where there will be so many competing offers for the property in question that you will have little control over whether your offer gets accepted. But these situations should be the exception, not the rule. If you find yourself repeatedly in situations where you are in bidding wars, it is because you are identifying opportunities that are widely known to the general public. Instead, you should be sourcing your deals to maximize the number of opportunities where you are either dealing one-on-one with the seller or the number of competing bidders is limited because the property is not being advertised on the open market. Remember that a significant part of what makes real estate unique in its ability to create wealth is that it suffers from market inefficiency (i.e., buyers and sellers do not always know about each other). The more often you are able to capitalize on this inefficiency, the more consistently you will put together deals that generate significant profit.

Your goal is to structure deals so that you accomplish your objectives with respect to each of the Deal Quadrants listed below while still addressing the needs of the seller. Each Quadrant has a spectrum of negotiation where you will either do very well in terms of achieving your objectives or you will have to concede the Quadrant to varying degrees.

Price	Terms
Time	Condition

The extreme example of having to concede in virtually every quadrant is the foreclosure sale. At a foreclosure sale, the sale price is discounted and therefore you can do well in Quadrant One but let's look at the other quadrants. You must pay all cash and therefore no financing terms are available (Q2: Terms), you must pay the entire sales price at the close of the

bidding and therefore you do not have the luxury of an contract period (i.e., Q3: Time) and you do not have interior access to the property (Q4: Condition).

Why can the seller, in this case the auctioneer for the lender, compel buyers to concede in all but one quadrant. Because a foreclosure sale is a relatively efficient marketplace. Information on which properties are going to sale is widely available. Numerous websites track this data and make it available either for free or at extremely affordable rates. Numerous courses are available to learn how to navigate the foreclosure sale process. As a result, almost every would-be investor is exposed to the information. Your ability to structure your offer is therefore limited literally to raising your hand and yelling out a number that is higher than the person next to you. You might occasionally acquire decent deals this way, but this should not be the extent of your deal sourcing strategy.

Depending on the particular opportunity that is presented to you, you may decide to concede one or more of the Deal Quadrants even in circumstances where you have no competition because it is advantageous to do so. But, it is important to understand that each quadrant is at play in every deal and the decision to make a concession on one or more of these points must be a conscious decision. An extremely effective strategy is to push hard on one quadrant knowing that you will concede another. In other words, use the quadrants that you will concede as bargaining chips to ensure that you achieve your objectives on the important quadrants.

Regardless of the deal, however, the most important rule in negotiating deals is that you must always be prepared to walk if the deal does not meet your investment parameters. As incredible of a deal as this particular opportunity might seem to be, there is ALWAYS another deal around the corner.

Strategy #1
Always be prepared to walk.

Price

It is extremely important to understand the process of setting your offer price, because few things annoy a seller more than the feeling that they are being arbitrarily low-balled by a predatory investor. Part of what creates this impression, is an offer where the price seems to have been plucked out of the air without justification. Instead, your price should be the product of well-defined investment parameters as well as systematic due diligence.

Strategy #2
Where possible, share your analysis with the seller.

The Rule of Correspondence: Price for Cash Flow

When buying cash flow, you must have already decided what you are willing to pay for a certain stream of income *prior* to even considering a specific investment opportunity. Recall that the price you pay for a stream of income is measured by the cap rate because the cap rate is the rate of return you will get on your money without the effect of leverage. For example, when I started acquiring apartment buildings I wouldn't consider any building that didn't have a cap rate of 12%. This meant once I determined NOI, I would adjust my offer price until the resulting cap rate was 12% or better.

If you know that you need a cap rate of 12%, for example, then the most important number to verify in arriving at the appropriate offer price is the NOI.

Building A

Purchase Price: $1,000,000
NOI: $100,000
Cape Rate: 10%

In order to increase the Cap Rate on this building from 10% to 12% you would have to lower the purchase from $1,000,000 to $833,333.

Building A

Purchase Price: $833,333
NOI: $100,000
Cape Rate: 12%

Arbitrarily telling the seller to lower the purchase price by over $100,000 on this building may not be well received. Let's further assume that the seller believes that a 10% cap rate is fair for the building based on the buildings that have recently sold in the market. If you do not adjust the cap rate but instead demonstrate that the current NOI is inflated, the seller may be more receptive to a drop in purchase price.

Strategy #3
A drop in current NOI drops the purchase price by the same percentage, so if you expose faulty assumption in the expenses the price will drop automatically.

Let's assume on Building A I believe that I can get the NOI to $100,000 eventually but it is not currently performing at that level. If I can show that the current NOI is really only $83,333, the appropriate price for the building at a 10% cap rate would be $833,333.

Building A

Purchase Price: $833,000
NOI: $83,300
Cape Rate: 10%

So how do I attack the NOI. Remember NOI is

Gross Income
Minus Vacancy Factor
Minus Operating Expenses

This means you essentially have three areas of focus (1) whether the gross rents being collected are being accurately stated, (2) whether the appropriate vacancy factor for the area is being used and (3) whether the operating

expenses are being accurately stated and if so whether the appropriate expenses are being incurred to ensure that long term maintenance of the property. We will discuss the process of obtaining and examining this information more when we discuss due diligence.

Price for Flipping

The most important thing to keep in mind when flipping either a single family residence or an income producing property is that the fair market value of the property is not necessarily the same as your resale price. In order to arrive at your offer price when flipping a property, you must back into the offer price by determining your resale price and then subtracting your renovation costs, holding costs, sales costs and other transaction costs.

The resale price is a function of how quickly you want to sell the property. A quick sale typically requires you to discount a fully renovated property 3-5% below the fair market value for the property. This discount must be factored into your analysis. When sharing your analysis with the seller, the important thing to point out is that the appropriate price for the property is not the market price for a standard sale but the market discount for a distressed sale (assuming of course that you are targeting motivated owners/sellers). For example, if the standard discount at a foreclosure sale is 75% of fair market value, then a 25% discount would be one way to arrive at an offer price to the seller. Remember, avoid arbitrary offer prices.

Strategy #4
When buying distressed property, market sales are not the appropriate comps. What is relevant is the quick sale price.

Terms

Terms generally refers to all of the key deal points beyond the offer price. Typically this includes contingencies (financing contingencies, appraisal contingencies and inspection contingencies) as well as the financing structure itself. A contingency is an event that must happen in order to trigger your obligation to close. If a contingency is not satisfied you do not have to close and are entitled to a refund of any earnest money previously deposited. From the seller's perspective, an offer with a lot of contingencies is not appealing so use them sparingly.

Strategy #5
Do not make contingencies of things you don't really care about.

For example, if you are absolutely comfortable with the purchase price based on your own research, it would be strategically advantageous to explicitly waive the appraisal contingency. This tells the seller, "Don't worry. This deal is not going to blow up because of a whacky appraisal."

When you plan to obtain traditional financing, your offer will include a financing contingency that will include conditions like the obligation to close only upon receiving a certain interest rate or loan-to-value ratio. When traditional financing is not available or undesirable, deals can still be consummated using a variety of alternative financing techniques that can be built into the overall deal structure. The more creative you get with the financing terms, the higher the purchase price will typically need to be to compensate the seller for accommodating your creativity. An all cash offer will frequently be accepted over an offer that includes creative financing even when the all cash offer is significantly lower. For this reason, your ability to structure deals using creative financing techniques will in part be a function of how many competing offers you are up against. Even one reasonable offer from a secondary buyer could be enough to cause the seller to reject an offer that includes creative financing.

Nevertheless, there may be cases where creative financing will be the only way to get your deal done. Be prepared to concede aggressively in the other quadrants in order to secure the necessary financing structure. You may even have to concede on the Price Quadrant.

Strategy #6
When pushing for a creative financing structure, be prepared to concede aggressively on the other quadrants.

Although there are others ways to structure financing, I will cover the three that are most likely to be recognized by and agreed to by the seller: 1) Subject-to, 2) Wrap Around Mortgages and 3) Seller Carrybacks.

Subject-To

A common way to put deals together when you are getting started and do not have the financial wherewithal to buy properties outright is to acquire them subject to the existing financing. Buying a property "subject-to" simply means that you will not be obtaining a new loan. The existing financing will stay in place and you will simply take over responsibility for paying the mortgage.

Consider the following example.

Building A

Purchase Price: $1,000,000
Existing Mortgage: $800,000
Interest Rate: 7%

In order to close on this building subject-to, you would pay the owner cash of $200,000 and take the responsibility of paying on the $800,000 mortgage at 7%. Note that the ultimate responsibility for the mortgage remains with the seller, which is why not all sellers are open to this structure. The seller remains on the hook until the property is refinanced or sold. Most sellers will, therefore, require that this mortgage be retired quickly.

Seller Carryback

Another alternative to traditional financing is a seller carryback. Seller carryback refers to the treatment of a portion of the purchase price as a loan by the seller. Assume that in the purchase of Building A for $1,000,000 you were only able to qualify for a $700,000 traditional loan and you only had $200,000 in cash. You could structure your offer so that the seller made a loan to you for the remaining $100,000.

Building A

Purchase Price: $1,000,000
New Traditional Mortgage (recorded as a 1st lien): $800,000
Seller Carryback (recorded as a junior lien): $100,000
Cash to close: $100,000

This is called a seller carryback because the seller is carrying back paper, which is another term for accepting a promissory note (the legal document that evidences the obligation to repay the $100,000 loan). A seller carryback structure requires the approval of the primary lender because the mortgage securing this promissory note is recorded as a junior mortgage against the property.

You can also combine the subject-to and the seller carryback strategies. For example, you could take a property subject-to and also request that the seller carryback an additional portion of the purchase price. As we discussed above, the seller's willingness to entertain these options will depend on the seller's motivation to sell and the number of competing buyers interested in the property.

You would be surprised at what a highly motivated seller with limited options will entertain. A win-win transaction, however, needs to address whatever happens to be motivating the seller.

Building A

Purchase Price: $1,000,000
Subject to Existing Mortgage (recorded as a 1st lien): $800,000
Seller Carryback (recorded as a junior lien): $100,000
Cash to close: $100,000

Wrap Around Mortgage (All Inclusive Deed of Trust)

A wrap is similar to taking the property subject-to in that the existing mortgage is not being paid off as part of the purchase. The difference is that with a wrap a new loan is created in favor of the seller that "wraps around" the existing mortgage. A wrap around mortgage is another way of achieving the same thing we achieved above by combining the subject-to structure with the seller carryback.

Let's assume that you couldn't qualify for a traditional loan on Building A and you only had $100,000 in cash. You could offer to buy Building A by offering a promissory note to the seller in the amount $900,000 at 8% and cash of $100,000. You would make payments to the seller on the $900,000 mortgage and the seller would make payments to the existing lender on the old $800,000 mortgage.

Building A

Purchase Price: $1,000,000
Existing Traditional Mortgage (recorded as a 1st lien): $800,000
Wrap Around Mortgage (recorded as a junior lien): $900,000
Cash to close: $100,000

Sometimes a seller will opt for a wrap in order to create an interest rate spread between the old mortgage and the wrap mortgage.

Purchase Price: $1,000,000
Existing Traditional Mortgage: $800,000 @ 6%
Wrap Around Mortgage: $800,000 @ 8%
Cash to close: $200,000

For this reason, if you are structuring an offer that includes a wrap around mortgage it is advantageous to propose a rate higher than the rate on the existing loan. In addition to the opportunity to generate extra income from the interest rate spread, sellers sometimes also prefer this structure because they can protect their credit by ensuring that the mortgage payments are made in timely fashion to the original lender (remember that on a subject-to deal you are paying the original lender).

On the other hand, I have heard many horror stories of sellers keeping the mortgage payments they receive and not making payments to the lender. As a result, when using this structure you absolutely need to ensure that you have access to the lender directly to check on the status of the loan at all times. Otherwise you could find that a building that you have been faithfully making payments on is in foreclosure.

Although this is not an exhaustive list of the ways in which deal financing can be structured, it is intended to illustrate the variety of alternatives to

traditional financing that are commonly used to put deals together that otherwise would never get done. These offer structures and others like them have served as the bridge that has enabled the undercapitalized upstart investor to cross over into the world of wealthy property owner.

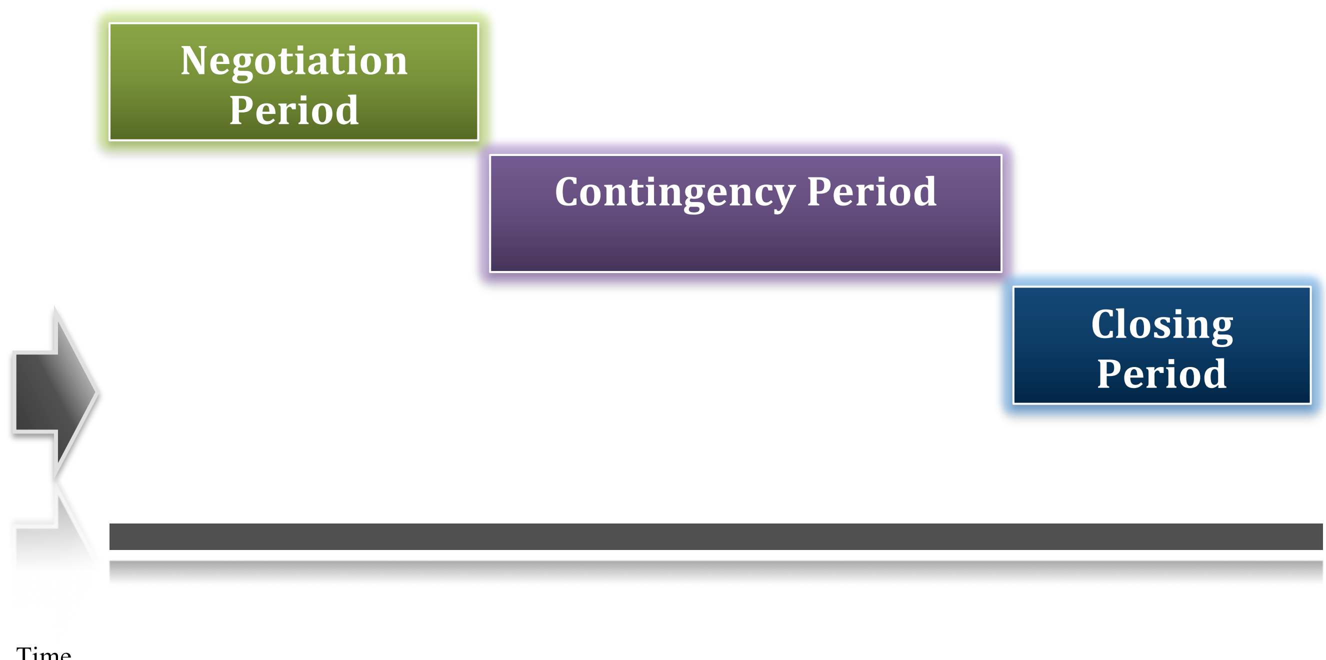
Note on the Due on Sale Clause

Loan documents invariably have a provision called a due on sale clause that allows the lender to accelerate and call due the entire balance of a loan in the event of an unauthorized transfer of the property. In both the case of a subject-to deal as well as a wrap around mortgage, the due-on-sale clause will be triggered unless the lender authorizes the transaction. In most cases the lender does not authorize the transaction and the risk of acceleration is inherent in this type of deal structure.

Strategy #7
Never take rejection personally. It's a numbers game. The more offers you make, the more deals you will secure on favorable terms.

Time

Hasty decisions in real estate can be extremely costly. Therefore, the amount of time you have during various stages of the transaction will affect your ability to achieve your deal objectives. There are several important milestones in the acquisition process, and the amount of time you have prior to reaching each milestone is always a negotiable item. The key milestones are:



Time

Negotiation Period

The Negotiation Period is the period prior to entering into the purchase agreement and committing to an earnest money deposit. Sometimes a seller, especially banks, will want you to inspect the property prior to making an offer so that your offer can be made without an inspection contingency. During the negotiation period you are particularly vulnerable to losing the deal to other investors who are also negotiating with the seller. An effective way of eliminating this risk is by using an option contract. An option contract is an agreement pursuant to which you pay the seller a fee, known as the option fee, in exchange for the right to enter into a purchase

agreement upon specified terms at some future date (e.g., 3 months later). You are essentially paying for the right to "lock up" the property for some period of time while you either secure the necessary capital to close, conduct more extensive due diligence or pursue some other objective that will enhance your overall position in the deal. The only penalty for failing to move forward on the purchase is the forfeiture of the option fee, which can often be set at a relatively low amount.

Another way to extend this negotiation period is by entering into a lease option. A lease option is a lease agreement that includes the right to acquire the property based upon pre-negotiated terms. It is sometimes advantageous to use a lease option when there is uncertainty in the market and you want a better sense for where the market is going before committing to the purchase of the a building. Lease options can typically be structured for much longer periods of time than an option contract.

Contingency Period

Contingencies drive most real estate transactions, so it is critical that we have a firm understanding of what a contingency is and how it works. A contingency is anything in a transaction that must be satisfied prior to some other obligation coming due. X has to happen before Y is required to happen. Since the buyer's primary obligation in a PSA is to purchase the property a contingency in a PSA typically refers to some condition that has to be met in a way that is satisfactory to the buyer before the buyer is obligated to buy the house. Because the term "satisfactory" can be as wide open as a Canadian prairie, the art of negotiating a PSA often involves a power struggle between the buyer and seller over how broadly or narrowly the buyer's satisfaction is defined at the outset. If the buyer's satisfaction is completely subjective for the duration of the escrow, the buyer will have the ability to cancel the deal for just about any reason right up to the day of closing. For example, let's assume you inserted a contingency in the contract that said, "Buyer's obligation to close is subject to the approval of Buyer's partner." What does that mean? Who is buyer's partner? How would the seller really know that the buyer was ever committed to the deal?

If, on the hand, the contingency is very specific, there will be no dispute about when the condition is met. In general, the more contingencies there are in an offer, the weaker the offer. Sellers view contingencies as a way to back out of the deal. But, in some sense this is exactly what you want. You want a way to back out of the deal without being penalized. To protect the seller from perpetual uncertainty in a deal, contingencies are always coupled with a time fuse (e.g., 10 days to inspect). At the expiration of this period, buyer must either:

1. Give the seller the opportunity to correct the issue (e.g., submit a request for repairs or request to resolve title issues)
2. Waive the contingency and proceed with the transaction (i.e., buyer can no longer object to the deal for this reason)
3. Or cancel the deal

There are literally dozens of contingencies that can be inserted into a contract for the buyer's protection. But, it is important to be strategic about which contingencies you include in the offer because they can

make or break the deal. Below we will discuss some of the more common contingencies.

- Loan Contingency
- Appraisal Contingency
- Inspection Contingency

Loan Contingency

Once a purchase price is determined, the financing terms must be decided upon. If you are buying the property all cash, there is no need for a loan contingency. If on the other hand, you plan to get a loan, the lender's decision to make the loan is out of your control and therefore you will typically insert a loan contingency into the offer. A loan contingency means the buyer must obtain a loan on terms at least as good as those specified in the PSA or the buyer's obligation to purchase the property never matures. For example, you might specify that if you don't get a 30-year fixed at a 5% interest rate or less, you don't have to close. It is important when inserting such a contingency that the terms of the loan be reasonable, because if you insert terms that professionals in the industry know are unattainable if looks like you are playing games. In other words, if prevailing interests rates are at 6% and you specify that you don't have to close unless you get a rate of 5%, then everybody knows all you are doing is leaving the back door open.

Often the period of time set for the expiration of the loan contingency will expire prior to receiving full loan approval, and you will be forced to gamble on the likelihood that the lender will actually go through with the deal. Where possible you want to push for the loan contingency to remain in place until the loan is funded even if all other contingencies have been waived. As you might imagine, you will need to have a considerable amount of bargaining power in your favor to get the seller to accept this.

STRATEGY HIGHLIGHT

All Cash v. No Loan Contingency

Many real estate agents treat an all-cash offer as equivalent to an offer with no loan contingency. They are not the same thing. There is a subtle but strategically important distinction between the two. An all-cash offer means you are not getting a loan. An offer with no loan contingency means you might attempt to get a loan but the deal is not contingent on the loan getting approved, and you are prepared to close anyway or forfeit your deposit. This subtle distinction can be an extremely powerful strategy when making offers.

When I got started in the business, there were a lot of investors making cash offers on distressed property. I wasn't in a position to make an all-cash offer. So, I made offers with no loan contingency instead because I realized that many real estate agents don't read the contract carefully and equate the two. I was willing to forfeit my deposit if the loan wasn't approved because at least I had a shot at the deal. I never lost my deposits because I was always able to close.

In this business, you will have a significant advantage in negotiating if you actually read the contract. You have a even more significant advantage if you understand that sometimes your deposit is simply the price of getting to the table and there will be times when it is worth risking the loss of your deposit in order to get to certain tables. Using your deposit this way is effectively the equivalent of a *option contract* where you pay for the right to have a certain amount of time to evaluate a property before committing to a contract. The difference is that most sellers will reject an option contract, but they will accept a PSA with a deposit even if the deposit is exactly the same amount as the price that would have been paid under the option contract.

Appraisal Contingency

Closely tied to the loan contingency is the requirement that the property appraise for a certain value, usually but not always the purchase price. Most often this is a lender condition. But, what many investors don't realize is that the contingency can be imposed whether or not a lender is involved in the transaction. When a property is deeply discounted, however, the seller may decide to reject an appraisal contingency on the grounds that no reasonable appraisal could conclude that the property is not being purchased below market and as a result there is no reason to give the buyer this out. If you are confident about the price, an appraisal contingency only weakens the offer.

Inspection Contingency

The buyer's fundamental right to inspect a property is not to be confused with an inspection contingency. Remember, a contingency is a condition that if not satisfied gives the buyer the right to cancel. You might be afforded the right to inspect the property before making an offer, for example, and then be required to write the offer with no inspection contingency. A seller might insist on this deal structure if the property needs a significant amount of work. In essence, the seller is saying "I know the property is a mess, so poke around as much as you like but I'm going to continue to market the property until someone is ready to move forward and close." In most cases, buyer's satisfaction with the condition of the property will be a contingency of the transaction. If so, what is a justifiable reason for canceling a transaction based on the inspection contingency? This is where the buyer's discretion is broad. Susan Buyer, for example, subscribes to the principles of Feng Shui, an ancient Chinese practice of site selection and configuration. Susan decides not to buy 456 Jupiter Pl. because when she opens the front door she can see the backyard and is concerned that the energy of the house is escaping inappropriately. Is Susan entitled to receive her deposit back? Absolutely. In fact, many professionals are under the mistaken belief that the buyer's inspection contingency is limited to the house and the lot. But, rejecting a house because of the results of a sexual offender search is perfectly appropriate, which of course is a decision based not on the house at all, but on the surrounding neighborhood.

Removal of All Contingencies

There comes a point in a transaction where the buyer is required to remove all contingencies. This is where the power balance shifts. Up to this point the buyer is conducting inspections, ordering appraisals, verifying title, and submitting documents to the lender for loan approval. Termite reports, roofing certifications, occupancy certifications, geological surveys, all are designed to provide the buyer with full disclosure concerning the condition of the property and anything that may be affecting its value. Relatively broad discretion is accorded buyer during this part of the transaction. Our real estate system is designed to give the buyer a free look, as it were.

At the end of the contingency period (that time allotted to get loan approval, conduct inspections, confirm value, etc.), the are two ways that contingencies can be removed:

- Passive Method
- Active Method

The *passive method* means that if the buyer doesn't do anything, the contingencies are automatically removed, the deposit becomes nonrefundable and the buyer is assumed to be proceeding to close. Where this method is used there is potential for the buyer to get locked into a deal inadvertently. Failure to watch the calendar or failure to count the days properly (e.g., calendar days v. business days) could result in the loss of the right to cancel.

The *active method* requires the buyer to affirmatively waive in writing all contingencies or it is assumed that buyer is not moving and is entitled to the return of the deposit. Typically, where the active method is used the seller has the right to issue a notice to buyer demanding performance or cancellation.

TIP

The active method is more advantageous to the buyer, so if you are in a market that uses the passive method in its PSA's consider modifying it to the active method.

Closing Period and Occupancy

The close of escrow is a date that is actually negotiated at the beginning of the transaction and is stated either in terms of a time period (30 days from acceptance) or a date certain (January 1, 20xx). But, what should be negotiated more often is what happens with respect to occupancy at the time of closing.

This can be particularly problematic when purchasing a property from an owner that is actually occupying the property. The seller's argument is, "I don't want to move until I have a check in hand because anything can happen at the last minute" (and indeed many things do happen at the last minute). The issue is that if the seller remains in the property after title has changed hands, the seller becomes a tenant. I once purchased a property and the day after closing the seller, who had been living in the property for 20 years, said the deck was unsafe for her child and threatened litigation if it wasn't fixed immediately.

More importantly, if the seller refuses to move (because for example the purchase of their new home fell through) you would have to initiate a full blown unlawful detainer action to evict the seller. So, either the seller should grant possession at closing or the seller should be regarded as a tenant to the extent the seller remains in possession beyond the closing and standard landlord/tenant safeguards should be applied.

In the commercial context, it is important to require the seller to deal with any problem situations before taking possession. For example, if there is an occupant engaged in criminal activity on the premises, you might not want to inherit that problem. If for some reason the seller is unable to address the problem, you should negotiate some sort of concession for agreeing to take on this situation.

TIP

Take a moment to celebrate when you close. It is very easy in this business to go, go, go and never stop to acknowledge your achievements.

Condition

Most investment opportunities that have the potential for significant cash flow or significant upside in value are distressed properties. Owners that have well managed buildings and adequate cash reserves are rarely incentivised to discount their properties and typically have the time to wait for the highest offer. Motivated Owners/Sellers with distressed properties typically do not have the cash reserves to fix their properties or they probably would have already. Your strategic objective, therefore, in examining the physical condition of the property is not to go back to the seller with a long list of repairs. Built into the discounted sales price is the recognition that the property is not in perfect shape. The point is to (1) make sure you know what you are getting yourself into in the way of renovation and (2) to identify significant deficiencies that may serve as the basis for a further price reduction. Do not annoy a seller that is selling a property $100,000 below market by pointing out a loose faucet handle.

Deal Strategy #8
Do not nickel and dime the seller.

Focus on the big-ticket items--the roof, the plumbing system, the electrical system and structural issues. If you identify a costly problem with the building that you don't believe has already been accounted for in the sales price, you should renegotiate the sales price as opposed to asking the seller to fix the issue. Hazardous conditions like mold remediation always justify revisiting the price if they have not already been taken into account.

One significant exception to the general rule that you should avoid asking the seller to cure conditions is an occupancy issue. If the property is occupied by a problem tenant, you may very well want to insist that the seller deliver the property vacant.

Writing Offers

To succeed in real estate, you must make offers, lots of offers. This means your primary deal-making tool will be a purchase and sale agreement (PSA). A PSA is a chessboard where the strategic posturing begins with the initial offer and does not end until the keys are delivered to the buyer from the seller.

The first step is called the offer and the buyer makes an offer by completing the purchase agreement on terms acceptable to the buyer, including the purchase price, financing terms, inspection terms and the closing date. There is no deal until there is an unconditional acceptance from the seller. In other words, if the seller changes even one term of the original offer there is no deal; there is instead a counteroffer back to the buyer and the parties must go back and forth until they reach a final agreement. In real estate that final agreement cannot be reached over the phone. It must be in writing.

Who is making the offer?

Since the buyer initiates this process, you must first decide who the buyer will be on the contract—husband and wife, just wife, The Profitable Corporation Inc., or The Prudent Family Trust. This decision is far more important than people tend to think because the buyer on the PSA will also be the borrower on the loan if there is financing. Let's assume Peter and John are business partners and decide to buy an office building together for which they plan to secure financing. Both partners insist on being listed as the buyer. Turns out Peter hadn't been quite as attentive to his bills as his partner. The bank will decline the purchase loan on the entire purchase based on Peter's credit. The partners, dejected and embarrassed, could approach the seller and request an amendment to remove the Peter, but this will often become a new point of negotiation and could result in the extraction of another concession by the seller.

STRATEGY HIGHLIGHT

And/Or Assignee

Identification of the buyer can actually be used strategically as a source of additional income. To implement this strategy you would make your offer as "John Doe and/or assignee." Writing the offer this way gives you the right to assign the contract to any legal party. This new party can step into your shoes as the new buyer. As a result, you have maximum flexibility. You can proceed with the purchase, add a business partner or sell the contract.

The price that the contract can be sold for will depend entirely on how good of a deal it is. If you were able to tie up a property at a price that is $100,000 below market, for example, you would be able to sell that contract for considerably more than a property that was $20,000 below market.

Word of caution. Because of the undisclosed identity of this potential new buyer, sellers are not always comfortable accepting offers written this way. If there are other comparable offers on the table, the seller will always accept an offer without the "and/or assignee" language. As a result, you may risk losing a great deal by writing offers this way.

Who is accepting it?

The person or entity accepting the offer must be the same person or entity that owns the property. Sounds obvious but even sellers represented by experienced agents make this very basic mistake. How? Let's assume John Seller buys a rental property. John's understanding is that real estate investors are savvy and shrewd, so John does some reading on asset protection and transfers title to the rental property to his newly formed company, Just The Beginning LLC, a California limited liability company.

Six months later John decides to flip the property, gets an unbelievable offer and, already counting his riches, signs on the spot in his personal name. The parties will discover later in the transaction that they do not have a binding contract because John no longer owns the property. Just The Beginning LLC owns the property and, therefore, only this entity can sell the property. If John were to attempt a 1031 tax deferred exchange of this property with another rental property, he might find himself in a difficult spot because his newly formed LLC would have to qualify for the loan on the new property which is unlikely. As investors, we must consider our plans for a property when deciding how title should be held and bear in mind that the seller is the person or entity that holds title to the property.

Another common wrinkle occurs when the former owner is deceased and the seller is the probate estate. Sometimes the probate court will need to approve the sale, which could mean the earnest money deposit is tied up for months only to have the entire transaction rejected by the court. A significant price discount might make the risk worth taking. The point is to understand the risk.

There is nothing necessarily bad or good about any of these scenarios. They simply underscore the point that the identification of the buyer and seller should be taken seriously. Just a little caution when identifying the parties to a real estate transaction can save a lot of frustration later in the deal.

Earnest Money Deposit

An earnest money deposit is an amount of money that you are willing to deposit with the facilitator of the transaction (lawyer, title company, escrow company) to demonstrate that you are serious. The bigger the deposit, the more serious you appear to be. In each market there will be a certain deposit amount that will be considered acceptable (e.g., 3% of the purchase price). You should get this information from a local real estate agent prior to making offers. You don't want to lose a great deal because a competing buyer was willing to put up an extra $1000.

The danger, of course, is that most PSA's make the deposit non-refundable in the event of a default by buyer or the expiration of a

certain date. PSA's are highly date driven. There is the offer date, the acceptance date, the date the deposit must be made, the date when all contingencies must be waived, and the close date. To protect your deposit you must know which are the important trigger dates. Does the clock start running on your deposit, for example, from the date of the offer or the date of acceptance?

It is sometimes useful to map out the transaction on a calendar so you know what is supposed to happen by when so you can make sure you have the right players doing their part in a timely fashion. If possible, it is also important to make sure that the contract stipulates that if you decide to pull out of the transaction, the facilitator is authorized to release your deposit without any further instruction from the seller. Seller's can sometime be vindictive when you cancel a deal and refuse to release your deposit even when they know you are perfectly entitled to get your money back.

If a deal doesn't work out for whatever reason you want to be able to move on to the next one as quickly and as painlessly as possible.

STRATEGY HIGHLIGHT

Per Diem Penalty

One of the most powerful and underutilized terms in the PSA is the per diem penalty. "Per diem" is Latin for "each day," and it refers to a penalty that is assessed against the buyer for each day that the buyer doesn't close escrow on time. Most buyers negotiate fiercely against the inclusion of this provision on the basis that it unfairly penalizes them for something that is generally outside of their control like the lender not funding when they are supposed to. These buyers do not realize how much they are hurting their cause.

The best way to explain the potency of this provision is by example. Let's assume you find a property that would be worth $150,000 with a little renovation. You think you can get an offer of $100,000 accepted but the listing history of the property reveals that the property has fallen out of contract with two previous buyers so the seller is wary. Seller is looking for a serious buyer before accepting a third offer.

What message do you think it sends to the seller if you voluntarily insert a per diem penalty of $100 per day for every day past the designated closing date of 21 days? Exactly! It tells the seller you are serious. Now let's further assume that you think it is possible to close in 21 days if everything goes precisely the way it is supposed to but there is a good chance that it could end up taking 30 days to close. You might still include the per diem penalty. Why? Because 9 extra days will cost you $900. Is it worth $900 to get your offer accepted on a property that is $50,000 below market? Of course it is.

You can either pinch pennies or make dollars. You cannot do both at the same time.

Notes:

CHAPTER 6
DUE DILIGENCE

Due diligence is one of those terms that is thrown around a lot without much explanation as to what it really means. It's an industry term that makes you sound like you know what you are talking about when you use it. Our goal here is not to sound sophisticated, but to really understand what we are doing.

The process of performing due diligence is essentially the process of ensuring that you are actually buying what you think you are buying. Due diligence actually begins before you even make an offer on the property and continues throughout the transaction until the deal is closed. One of the reasons you never want to get too attached to a deal is that something can pop up at the last minute that changes the entire economics of the deal and calls into question whether the property is worth pursuing.

The factors that are important to conducting a thorough investigation of the property include:

- Value (we will discuss residential and commercial value separately)
- Physical Condition
- Financial Performance
- Tenancy
- Management
- Surrounding Market
- Government Issues & Legal Issues

We will discuss each one of the factors in turn. You will find that over time you develop your own way of investigating a property that might involve the gathering of additional information. The questions and resulting information discussed below are the more common due diligence items.

Residential Value (Comps)

The fair market value (FMV) of a property is the price that would be arrived at in an arm's length negotiation between parties that had a reasonable amount of information about the property and relatively normal motivations. It is what you might refer to as the retail price. Obviously, it is impossible to flip a property for short-term gain if you pay retail for the property going in. But, even if you want to acquire the property for long-term cash flow, you want the best price possible.

In the residential context, the most common way to determine the FMV of a property is by using comparable sales ("comps"). The analysis of comparable sales is basically the process of examining what similar properties in the area have sold for in order to determine what the property in question is worth. The question, therefore, is what does "similar" mean. Let's look at some of the more common factors:

- *Sale Date*: When looking at prior sales to determine their relevance, we have to decide how far back we are willing to look. For example, a property that sold two years ago would have sold for a very different price than a property selling now. The date range will depend on how fast the market is changing. In a rapidly changing market, you probably would not want to go back further than 3 months. In an extremely flat market with very few sales you go could probably go back one year. A pretty safe timeframe in a typical market is about 6 months or less. As with any rule of thumb, this guideline should not be followed blindly. You have to actually look at the results you are getting to see if the market six months ago is really still the market. In fact, I have seen markets changing at such a rapid pace that I had to rely on active sales (properties still on the market for sale) and/or pending sales (properties under contract) to really get a read on current market value.

- *Radius*: Radius refers to the distance of the comps from the subject property. The general rule is a one-mile radius. But as we all know there are certain neighborhoods that change dramatically when you cross the proverbial "tracks". The "tracks" could be half a mile away and as a result a one-mile

radius search could pull up properties that sold for significantly less or more than the subject even though all the other facts were comparable. This is another way of saying that it is rare that an online search will be enough to determine whether you are using valid comps. You must get in your car and actually drive the neighborhoods unless you are extremely familiar with the area.

- *Physical Specifications (Bed/Bath Count)*: where possible, you want to compare a three bedroom, two bathroom house to a three bedroom, two bathroom house, not a two bedroom, two bathroom or a three bedroom, one bathroom. Bedrooms are more important than bathrooms so you generally want to try to at least find a comp with the same bedroom count. Do not, however, totally discount the important of bathrooms especially in areas that are family oriented because parents prefer to not to have to share a bathroom with their kids. One bedrooms and studios tend to attract people who are not raising families (e.g., yuppies, retirees) and therefore cannot be used as a comparable for a three or four bedroom house.

- *Physical Specifications (Lot Size)*: Lot size is extremely market specific. There are markets where the lot size is almost entirely irrelevant. There are markets where a 6000-8000 square foot lot is important to the typical buyer's sense of home (anything above that being considered undesirably maintenance intensive, anything below not feeling like the dream home). There are markets where large lots (half an acre or more) are common and desirable. You must know the market to know where the lot size of your subject property fits in terms of its desirability. For example, if you are in a market where 6000-8000 square foot lots are the norm and you are considering a property that has a 4500 square foot lot, you need to understand that you might have to take a hit when you market such a property because of the lot size.

- *Physical Specifications (Year Built)*: The year a property was built is not only an indication of the condition of the property but often speaks to the architecture. In general, you want to

stick to comps that are within 5-10 years of the subject. The exception to this general rule would be if a significant building code requirement was imposed in a certain year (e.g., no lead based paint), then you want to be sure to use that year as an important demarcation.

- *Upgrades/Amenities*: A pool, an island in the kitchen, a deck, fireplaces, these are all things that can affect the value of a property. To the extent the subject property differs from a comparable property with respect to upgrades and amenities you will have to make a price adjustment.

Price adjustments are tricky. If you speak to appraisers they will tell you that they determine the appropriate price adjustment based on how much more properties in that area with the feature in question sell for. In other words, how much more do people typically get when they have a pool (it will almost always be less than what they paid to have the pool installed)? You might need to consult with a local real estate agent to get this information.

Commercial Value (Cap Rates)

In the commercial context, valuations are handled differently. Most professionals use cap rates to compare income producing properties because it is the easiest way to equalize properties that may have very different specifications. As we discussed in Chapter 2, the cap rate is the net operating income (NOI) divided by the purchase price. This ratio does not take into account mortgage payments. As such, it represents the return you would get on your money if you bought the property all cash. Because the cap rate is so important to determining the value of a property as it compares to other income producing properties in the area, you need to analyze the factors that affect the cap rate to determine what kind of a deal you are really getting.

- *Vacancy Factor*—In order to determine NOI, you must take the gross rents and subtract the vacancy factor. The vacancy factor is not the actual vacancy in the building. It is the expected annual vacancy represented as a percentage of gross rents. If rents for example are $100,000 per year, a 5% vacancy factor means that you can expect to lose $5,000 per year due to vacancy in the building. Listing brokers often state this number artificially low in order to boost NOI. You should check with local professionals in the market to find out what the true vacancy really is. I almost bought a 72-unit apartment building in Texas where the vacancy factor was listed as 10%. As I often do, I decided to take a drive around the neighborhood to get a sense for how many other apartment buildings were close by. Building after building was advertising very aggressive move-in specials in the form of banners and lawn signs. Upon further investigation, I discovered that the area was over saturated with apartment buildings and the true vacancy factor was between 20-25%. This was a deal breaker.

- Operating Expenses: Gross rents minus the vacancy factor gives you the effective gross income (EGI). EGI minus operating expenses gives you the NOI. If the operating expenses of a building are understated, the NOI will be higher than it should be. If the NOI is higher than it should be, you will pay more for the

building than it is worth based on a particular cap rate. Let's consider the following office building:

123 Broadway Blvd.

Gross Annual Income: $150,000
Vacancy Factor 5%: -$7,500
Effective Gross Income: $142,500
Operating Expenses: -$42,500
Net Operating Income: $100,000

Purchase Price At @ 10% cap rate is $1,000,000
If the operating expenses should really be $52,500 based on a more realistic portrayal of the performance of the building, the NOI would really be $90,000 and the purchase price would be $900,000.

As you can see from this example, adjustments to the operating expenses have a significant impact on the purchase price of the property. For this reason, it is extremely important to examine the operating expenses when you are conducting your due diligence. Typical operating expenses include:

- Gas
- Water
- Electric
- Landscaping
- Management (offsite, onsite)
- Legal
- Marketing
- Trash
- Pest Control
- Locksmith
- Cleaning
- Repairs
- Property Taxes
- Insurance

Physical Condition

Although you will typically rely on the inspection of a trained professional to assess the condition of the property, there are some basic things about properties that you should be aware of if you are in the real estate business.

- Plumbing: The main question concerning plumbing is whether the pipes are copper or galvanized steel. You want copper. Copper is biostatic which means bacteria hate it. Copper resists corrosion. Copper does not release toxic gases in the event of a fire. Need more reasons? Copper is more flexible and easier to install in narrow spaces and it is less likely to leak. There are no real advantages to galvanized piping relative to copper and as expected it reduces the value of the property. When considering the plumbing system you also want to test the water pressure. Low water pressure can result from corrosion in a fixture such as a showerhead (no bid deal) or from something more serious such as the size of the main supply pipe from the water meter to the house. Replacing a main line is expensive, so do not ignore low water pressure.

- Electrical: One of the biggest issues to be concerned about with respect to the electrical system in an older property is whether it has circuit breakers or fuses. Both are designed to prevent large power surges from destroying equipment and/or causing a fire, but they accomplish this in different ways. Fuses have a small piece of metal inside that melts when overloaded. The fuse must be replaced before electricity will flow again. Circuit breakers lip from "on" to "off" when overloaded and must be reset when "tripped." One of the reasons modern building codes require circuit breakers is because they are harder to tamper with. In the past fires have been caused by people replacing a blown fuse with one that handles an inappropriate amount of electricity before blowing thereby defeating the entire purpose of this safety precaution. A fuse based electrical system reduces the value of the property because at some point it is likely the local building department will require an electrical upgrade which is very expensive.

- Heating and Cooling Systems: Warm air rises. Keep this in mind when assessing the heating system. A forced air system is exactly what it sounds like—a device that forces the heated air through a network of ducts that deliver the air to the individual rooms of the property though vents called "registers." The disadvantage of this method is that it tends to create hot and cold zones because as the warm air emerges from the registers it rises to the ceiling making your head warmer than your feet. Radiant floor heating in contrast warms the floor and allows the heat to rise, which tends to create a more even distribution of heat. The reason most properties have forced air heating systems is that they work well with central air conditioning systems that can use the same ducts to pump cool air. Central air is a big selling point. An important point to remember about air conditioning systems is the Seasonal Energy Efficiency Ratio (SEER). If the property does not have an adequate SEER unit and something major goes wrong, you will have to upgrade the entire system.

- Roof: Roofing material comes in many varieties (composition shingle, tile, wood) and all of them leak. Water stains on the ceilings inside are a pretty good indicator that there is a problem with the roof. So when walking a property always remember to look up. Given the expense of replacing a roof, it is not a bad idea to get a roof certification if you have any doubts. Aside from the condition of the actual material used on the roof, there could also be a problem with adequate drainage. In other words, if water is collecting on the roof when it rains because the roof does not slope properly, this problem will eventually need to be addressed.

- Walls: Walls work better when they are actually standing upright. Warped or cracking walls could indicate a shifting foundation or other significant problems. Settling or shifting in the foundation may also be evidenced by doors that no longer close properly or corners that don't look perpendicular. Structural/foundation problems are serious and very expensive. Consider long and hard before taking on a property with structural and/or foundation problems. Consult with a geologist if necessary.

- Floors: If you set a ball on the floor of a room and it moves unassisted, that's bad. It means the floor has warped, typically because of excessive moisture or settling. Often this does not mean there is anything wrong with the structural integrity of the building but it is nevertheless a problem that might need to be address. If you walk through a room and the floor feels spongy that means that the subflooring is bad and will have to be replaced.

- Door, Windows and Glass: Windows do more than afford pretty (or not so pretty views). Windows are a means of egress in the case of an emergency. They need to be operational and not painted shut. If the property is near a busy street, they should be double paned to reduce noise from outside. If there's any chance that based on the position of a window someone inside or outside the property could impact the glass, then tempered glass should be installed in that location. Energy efficiency is also extremely important when considering windows and glass. The door to the garage in a house should be fire rated to protect the interior from incidents in the garage. Tenants sometimes install locks on the front door that require a key to open from both sides. These locks are a fire hazard and should be removed.

Financial Performance

The financial performance of the property will determine whether it will be an asset or a liability to your portfolio. It is critically important to pour over the numbers to make sure you are paying the appropriate price.

- Market Rent v. Actual Rents: When the actual rents are below market, listing brokers will often attempt to pitch a property based on the market rents. The assumption is that the current owner has not been diligent about raising the rents annually and that as the new owner you will have substantial upside by adjusting the rents to market and capturing the extra cash flow as well as the bump in value. The problem with this assumption is that adjusting to market value is not always feasible. Some cities have regulations that restrict the amount by which you can raise rent on an annual basis. For example, if you buy a property where the owner hasn't raised the rents for 10 years, tenants might be paying $400 per month in a market where current rents are $700. If there is a rent control regulation in force that prevents you from raising the rents more than 3% per year, for example, it would take 20 years of rental increases just to get to $700. For this reason, if you are buying a property in a city where there is a restriction of this kind on rental increases, you should only project market rent for the units that are currently vacant.

- Historical P&L v. Pro Forma P&L: A profit and loss statement summarizing the total income and expenses is an important tool in assessing of the financial profile of a property. When analyzing P&L statements be careful to distinguish between historical statements that show actual income and expenses from pro forma statements that might take part of a year's worth of expenses and project them for the whole year. The problem with such projections is that expenses like utilities can be highly seasonal. In some states gas bills can be over 200% higher in the winter than they are in summer. As a result, expenses based on only part of the year can grossly distort the real performance of the property.

- Actual Bills v. P&L Statements: Unfortunately, sellers do not always tell the truth about their actual expenses. Always insist on receiving the actual bills (utility bills, property tax bills, etc.). You will often find significant disparities between the actual bill and the P&L.

TIP

There are certain expenses that invariably increase when the ownership of a property changes hands. These expenses will almost always be stated at the amount being paid by the current owner as opposed to the amount that will be paid by you once you take title. The most common examples of such expenses are property insurance and property taxes. Landlords are notorious for underinsuring their properties. As a result, their insurance premiums will be understated relative to the current replacement cost of property. In addition, property transfers often trigger property tax reassessments that can trigger a significant property tax increase.

Tenancy

An income producing property is only as stable as the tenant base. The reason shopping centers want national, anchor tenants is to maximize the stability of their income stream. The most common way to verify the situation with the tenants in the property is by requesting a rent roll. The temptation, however, is to focus on the rent, which may not be the most relevant information on the rent roll.

- Occupancy Date: One of the first things I look at when I receive the rent roll is the occupancy dates (i.e., the dates the tenants moved in). If you are considering a 50 unit property where 20 of the tenants have moved in within the last 6 months, that generally means the owner filled the property with warm bodies in preparation for sale without applying normal screening criteria. The result: you take over the property and are immediately faced with a high eviction rate and heavy turnover costs. Ideally what you want to see is tenants that have been in the property for years, provided of course that you are not locked into rents that are significantly below market.

- Expiration: If a significant number of tenants are on term leases with expiration dates that are coming up soon, it is advisable to request something in writing from these tenants confirming their intention to renew their lease.

- Talking to Tenants: Whether or not you receive a rent roll, you should personally speak to as many tenants as possible. Tenants will tell you everything that is wrong with both the property as well as the neighborhood. This is one of the most fruitful forms of due diligence. I have seen more than one situation where a property looked great on paper until I started speaking to the tenants.

TIP

The quality of the current tenants in your property will dictate the quality of the tenants you are able to attract going forward.

Management

Properties can get away from you quickly if they are not managed properly. As a result, you must decide immediately whether you plan to keep all or a portion of the current management structure in place. Specifically, you are concerned first with whether there is an onsite manager and, if so, what arrangement is currently in place.

- Work for Rent: Many onsite managers started off as tenants occasionally doing handiwork for the owner. This informal relationship eventually matured into a more structured employer/employee situation where the manager's duties range from collecting rents to fixing leaks. As opposed to receiving a normal W-2 salary, onsite managers often barter services for either free rent or reduced rent. There are several problems with that arrangement. First, onsite managers typically do not log the time they work, so it is difficult to know whether they are really earning the equivalent of their rent. Second, when someone gets accustomed to artificially low rent, it is very difficult for them to adjust to paying full rent again. As a result, if for some reason you become dissatisfied with the quality of their work, the relationship will often result in a messy eviction. The eviction will be messy because it will be difficult to separate out wages from rent.

- Owner Managed: To save money many owners attempt to manage their own properties. Because they are not professional property managers, they often do not have standardized policies and procedures in place. When conducting due diligence, it is important to take note of this situation because it means you might inherit a tenant base that has grown accustomed to a lax management style. In addition, the owner will typically not include the value of his or her time as an expense on the P&L Statement.

Surrounding Market

Due diligence should not stop at the property boundary lines. In order to fully understand the financial viability of a particular property you must also understand the market factors bearing on it.

- School Districts: Whether you are buying a property to flip or hold for cash flow, one of the most important factors affecting the desirability of the property will be the quality of the school districts. Parents will pay a premium to live in a neighborhood that allows their children to obtain a better education. As a result, better school districts mean better tenants and more qualified buyers.

- Income Data: It is important to know whether the market will truly bear the rent you hope to achieve if you plan to market your property for rent. You will need to compare the amount you hope to charge for rent with the surrounding properties to ensure that you are in line with market. Census bureau data can also be useful in helping you determine the percentage of the population in that area that can afford your property.

- Broken Window Theory: The broken window theory was first advanced by criminologists James Q. Wilson and George Kelling in 1982. The idea is that evidence of neighborhood neglect like broken windows and graffiti can trigger more criminal behavior because it signals a general lack of order and authority. Accordingly, it is always advisable to drive around the property looking for signs of neighborhood deterioration. Graffiti doesn't necessarily mean you shouldn't buy the property, it simply means this is one more factor to take into account.

- Nighttime: Neighborhoods can sometimes look dramatically different during the daytime. Avoid buying properties without also driving the neighborhood at night. To the extent there are undesirable elements in the area, you are much more likely to see them at night than you are during the day.

- Highway access: Properties that have convenient access to major highways tend to rent faster and sell faster. In other words, if you find yourself getting frustrated when attempting to get to the property prospective tenants and buyers will also get frustrated.

Regulatory Issues

In addition to the neighborhood, the other major category of external factors that can affect the property is regulatory issues. Options slim quickly when you have a regulatory problem. In many instances such problems can and should be a deal breaker.

- Zoning: Early in my investing career I bought a four unit building with the intention of converting it to an eight unit building. I expected the conversion to be a relatively simple matter because the building was originally an eight unit building. As an eight unit building the gross rent would have been significantly higher and the market value of the property would have increased substantially. When I went to the building department to apply for the necessary permits, I was informed that after the building was converted to a four unit building by the previous owner the area had been downzoned, thereby prohibiting the construction of buildings larger than four units. I tried every argument in the book to obtain a variance that would allow me to convert the property, including the fact that the property was surrounded by larger properties (which made the inflexibility of the building department all the more exasperating). Nothing worked, not even a letter to the local congressman. Fortunately, the property was still profitable as a four unit building. Nevertheless, I never forgot the importance of checking on all regulatory issues that might bear upon your intended use for the property.

- Licenses and Permits: Licenses can expire, so to the extent that a license is necessary to use the property for its intended purpose (e.g., liquor license or license to operate an assisted living facility), you need to confirm that the license is still valid. If not, then you must decide whether the seller should be responsible for delivering the property with a valid license. If not, you need to decide whether you want to negotiate for an adjustment to the purchase price to reflect the fact that you are taking on an operation that could be shut down the day after you close. Same thing applies to permits, especially in the residential context. Property owners often convert garages into additional rental units or add on to their properties to get additional rental income.

These additions are often completed without the necessary permits, and more importantly are often not in compliance with the current building code. This means you could be buying what you think is a triplex, for example, and find out shortly after you close that the city is requiring you to tear down the third unit for noncompliance. This creates two problems: (1) you have lost one third of your income, and (2) if you are in a rent-controlled city you may be forced to pay substantial relocation costs to the displaced tenant. Red flags indicating that a unit was built without permits include:

1. Unusually low ceilings
2. Rooms that are not level (e.g., step down living room or master bedroom)
3. Long extension cords being used to connect lamps and other electrical devices
4. Exterior siding or roofing material that doesn't match the rest of the property
5. Odd shaped rooms
6. Having to walk through one bedroom to get to another bedroom
7. Windows that don't match the rest of the property, especially if the room is poorly lit.

TIP

Once you take title to the property you inherit all of the problems with the property. The point of a thorough due diligence process is not to ensure that you get a perfect property but to ensure that you are perfectly aware of all of the imperfections.

Notes:

CHAPTER 7
ADDING VALUE THROUGH MANAGEMENT

Profit in real estate often results from acquiring a property in a suboptimal condition and adding value to the property. The most common ways to add value is to either (1) improve the condition of the property by renovating it, which requires effective construction management, and/or (2) improve the cash flow of the property by implementing a more effective property management system. In this chapter we will first address construction management and then we will discuss property management. Keep in mind the two often intersect.

Construction Management

Effective construction management means more than just oversight. It means the implementation and execution of a systematic approach to a particular project in order to achieve clearly defined objectives.

HIGHLIGHT

Cornerstones of Construction Management

1. Clearly define your objectives.
2. Develop a systematic approach.
3. Carefully select the people who will help you execute this systematic approach.

Defining Your Objectives

When you are renovating a property, you must know what you trying to accomplish. Not every renovation project has the same goal and if you are not clear about the goal you will miss the mark. Three possible primary objectives are (1) functionality, (2) speed or (3) aesthetic appeal. On any given project you will to some extent care about all three but there are times when you care more about one significantly more than the others because of the demands of the market. Remember that you are not renovating this property for yourself, you are renovating it for a buyer that has certain priorities.

Functionality. There are times when your number one objective is to make sure everything works because the buyer will not pay a premium for frills. I walked a mobile park that I was investing in once and spoke to the residents that happened to be sitting outside on their decks. I asked them what they care most about when choosing a unit—paint colors, size, etc. Consistently, the answer I received was that the most important consideration was that everything works:

1. Do all the electrical sockets work?
2. Are there enough electrical sockets in every room?
3. Do all the toilets flush?
4. Are there any leaks in the pipes?
5. Is the water pressure adequate?
6. Do all the windows close properly?
7. Is the roof leaking?
8. Does the furnace work?
9. Does the AC work?
10. Do the kitchen cabinets open and close properly?
11. Is the floor tile pealing up and creating a trip hazard?
12. Is the deck stable?

When your buyer cares about functionality, you care about functionality. This means that a successful renovation project in this context is one where at the conclusion everything works.

Speed. Sometimes you want to get the property back on the market quickly. This might be because your profit model is based on maximizing the number of times in a year that you can rotate your capital. It might be because the market is changing rapidly and you are trying to liquidate before you get stuck with the property. Or it might be because you are working with a money partner that is not willing to commit their capital to the project for an extended period of time. Whatever the reason, the objective is the same—in and out.

In this case, it might be acceptable to you that certain things are not entirely operational because you plan to disclose these things to potential buyers and you believe the property will sell despite these disclosures. Success, therefore, is finishing on time.

Aesthetic Appeal. Certain markets call for attention to detail--surfaces matter, colors matter, fixtures matter. In such a market, you must know what the market considers appealing because this aesthetic standard will be the objective. For example, if you are in a market that calls for minimalism (less is better) and you order rails for the staircase that have a beautifully ornate leaf pattern, you might have difficulty selling the property. Attention to detail means you care about things like:

1. The style of the base molding
2. The spacing between the travertine tiles
3. The width of the hardwood floor planks
4. Whether the kitchen sink is undermounted or overmounted.
5. Whether the door on the bathroom shower is frameless or not.
6. The precision of the painting (i.e., no spray paint)
7. Faucets and fixtures

Maximum aesthetic appeal can only be achieved by eliminating distracting imperfections so the eye can focus on the beauty of the house and the design.

Systematic Approach

Predictability produces profit. Surprises in real estate rarely work to your advantage. The better you get at managing a construction job, the more predictable the outcome both with respect to time and money. Having said that no two jobs are exactly the same, so you will need to be somewhat flexible and responsive to the specific demands of the particular project. What you want to avoid is haphazardness.

Materials: To the extent possible you want to standardize the materials you use on your projects and the vendors you purchase your materials from. There are several advantages to doing this:

1. You will have a better chance of qualifying for bulk rate discounts if you buy repeatedly from the same vendor. Many of the big suppliers to contractors have a corporate desk where they structure discounted pricing for repeat buyers.

2. You will reduce the likelihood of contractors making their own sometimes questionable aesthetic decisions about paint colors, carpet textures, etc. I have ended up with lime green mobile home units, powder pink houses and industrial carpet remnants in properties because I didn't get to the contractor in time to instructor them on what to buy (or rather what not to buy).

Sequencing. One of the biggest problems for new real estate investors is deciding who should do what first. The obvious example would be the basic mistake of laying carpet before all the painting is done and then discovering that the carpet needs to be replaced because paint dripped on the new carpet. Even if you could get the painters to pay for the carpet they just ruined (good luck with that), you still have the delay of ripping the carpet out and installing new carpet after the painters finish. Although, every project presents its own challenges, here are some general guidelines:

HIGHLIGHT

Construction Sequencing

1. **Structural and framing issues**: to the extent you need to add support beams or in any way shore up the structural integrity of the property, you want to do that first (new investors should avoid taking on properties that have significant structural issues).

2. **Plumbing Issues**: fixing the plumbing requires you to open up walls, so you want to address plumbing issues early in the renovation process.

3. **Electrical Issues**: generally you want to address electrical issues after the plumbing because wherever there is water you will need GFI outlets. This means if you plan to move around toilets and sinks during the renovation the electrician will need to know the final location before doing the electrical work.

4. **HVAC:** Heating and Air Conditioning Units need electricity to be tested, so HVAC should be done after you have resolved any electrical issues.

5. **Windows**: replacing windows often requires you to damage exterior surfaces like stucco and exterior paint as well as interior surfaces like drywall and interior paint. As such, if you will need to replace windows make sure to do so before painting.

6. **Drywall**: Once you close up the walls you will not be able to get to the plumbing and wiring.

7. **Paint**: In addition to the reasons stated above, one of the reasons you want paint to be one of the last things you do is because once the house is painted you want to minimize the number of dirty hands that might get the freshly painted walls dirty.

8. **Flooring**: Flooring comes after paint so you don’t get paint on the carpet, hardwood floors, tile, etc.

9. **Landscaping**: Comes last so it doesn’t get trampled.

Selecting the Right People

The success of your projects will depend greatly on the criteria you use to select the people you will work with as well as the rigor with which you enforce your standards. I have seen it all. I have shown up unannounced at construction sites and seen guys watching soccer matches on a portable tv. I have seen doors installed upside down. I have seen floor tiles laid so crooked it looked like they were installed in the dark with one hand.

What you want is a reliable team—a team that performs consistently. They show up, they work hard, they travel if necessary. Loyalty works both ways. They will expect to be paid on time and in full. They will expect to be paid immediately upon completion of the work, not 60 days later. They will expect materials to be delivered when they are supposed to be there. Remember, every day they sit around unable to work is lost wages. Many contractors live paycheck to paycheck and simply cannot afford to lose too many days without work. They will not understand checks not clearing. They will not understand your phone not working on payday. On the hand, do right by them and you will have a loyal crew for years that will go to the ends of the earth for you regardless of the austerity of the work conditions. This is important because some of the most profitable projects will require you to assemble a crew quickly to stabilize a situation that is threatening the property.

The range of professionalism, workmanship and integrity is vast in the construction industry. High standards in each one of these areas will result in completed projects that you can be proud of.

Professionalism: Obviously professionalism in the construction industry does not mean a suit, a tie and an iPad. It means that the contractor runs their operation like a real business.

- License: It not enough for a contractor to simply present you with a license. You need to check to make sure the license is current and that it is actually in the name of the person to whom you are cutting the check. Often contractors will attempt to work under somebody else's license hoping that you will not bother to actually read it.

- Insurance and Bonding: Ideally the contractor carries at least $1Million of liability insurance and is bonded by a reputable company. What's the difference? The insurance covers things like a hammer falling off the roof and hurting somebody. Bonds cover two major situations:

    Performance Bonds - A bond that guarantees the project's completion according to the building plans and specifications.
    Payment Bonds - A bond that guarantees that to the extent a mechanic's lien is filed against the property for failure to pay labor and materials the party will be paid and the lien remove.

  Small contractors will not always be bonded but at the very least they should carry liability insurance. Part of the reason you want to see a valid license and at least proof of insurance is not only for your protection but because it says something about the level of professionalism of the contractor. It says that the person understands they are running a business and this attitude will carry through every aspect of their work.

- Bid Detail: Professional contractors generate detailed bids itemizing everything they plan to do for the price they are quoting. This detail is important because if something goes wrong at a later date you need to know whether this problem was within their original scope of work or whether it represents a new problem.

Workmanship: The old adage "You get what you pay for" couldn't be truer in the construction context. The cheapest bid is not always the one you want to go with otherwise you might very well end up with paint sprayed on your light switches. The problem is that rarely will a contractor be in a position to provide you with prior examples of their work. In addition, you will not always be able to find someone by referral if you are going into a new market or you are involved in a project that takes you outside of your normal circle.

One way to gauge the likely workmanship you will get is what I call the pride factor. When you speak to Peter the tile layer and you can see the pride as he describes the precision with which he lays tiles and the special trick he uses to get the spacing between the tiles exactly even you know you will get a good finished product. This pride, by the way, does not necessarily translate to higher rates; some people are just wired to do the best job they can no matter what they are doing and no matter how much they are being paid.

Regardless of how comfortable you are with the contractor's intent to do good work, you still need to make regular visits to the job site to ensure that you get the result you want. It also helps to have a final walkthrough checklist to ensure that as you walk the property, you don't miss anything.

TIP

Try having someone else do the final walkthrough of a renovation project. A new pair of eyes on the job will often notice things that you won't because that person doesn't have preconceived expectations going in. This is especially true with small details like handles, socket covers, recessed lighting, etc.

Protecting Yourself: It is impractical and inefficient to be at the jobsite every minute of the project. This means you will need contractors on your team that you can trust. Regardless of how trustworthy you believe your contractor to be, however, there are certain precautions you nevertheless want to take.

- Avoid buying tools and/or equipment for your contractor unless you have the ability to store them yourself in between jobs.

- Avoid allowing contractors who are working on an hourly basis to buy materials for the job unless you are present or get a precise itemization of the purchases. Contractors will sometimes buy materials for other jobs they are working on. This issue is less important for contractors working on a fixed bid price because your expenses are fixed.

- Avoid allowing overlapping crews as they will tend to compare and often distort compensation structures.

Property Management

Effective property management means more than just collecting rent. It means the implementation and execution of a model for how the property is going to operate. In large part property management consists of the following activities, which you can think of as stages in the property management cycle:

- Stage 1: Marketing rental units
- Stage 2: Screening prospective tenants
- Stage 3: Executing lease agreements
- Stage 4: Collecting rent
- Stage 5: Responding to maintenance calls
- Stage 6: Evicting tenants
- Stage 7: Turning units

As you can see from this list, this is a cyclical process of finding tenants, losing tenants and replacing them with new tenants. The higher the turnover, the lower your cash flow on the property because every time you lose a tenant you incur costs associated with that loss including:

- Lost rent
- Eviction costs if the tenant does not move out voluntarily
- Cost to renovate the unit
- Cost to market the unit

This means that the goal is to find long-term, stable tenants that will treat the property as if it were their own home. In fact, in some cases it will become home.

We will now discuss each of these stages in greater detail, but before we turn to that discussion, let's take a moment to cover some of the initial things you will need to do to get yourself set up.

Getting Set Up

One of the first things you should invest in if you are going to manage properties is well-designed software. There is a ton of property management software out there but it can get expensive. If you buy software designed to manage thousands of units you will likely be paying for more features than you actually need when you are just getting started. Most companies allow you to test their products before you buy it and the better companies will send out a representative to demo the product and explain how it will meet your needs. An important question to ask when considering software is how well it interfaces with accounting software like Quickbooks. A seamless interface will make tax preparation infinitely easier. Regardless of how good of a job the sales rep does, you will absolutely have questions as you use the software, so the company's policy towards customer service is critical.

Many of the forms you will need to operate your business (rental application forms, standard lease agreement, eviction notices, etc.) will often be included in the software. But inevitably there will be additional forms that you will need to complete your operation. Local apartment owner's associations are a valuable resource for such forms and other related information.

Finally, you will need the ability to check credit and do criminal background checks on prospective tenants. These services are usually priced on a per transaction fee which you can pass through to the applicant.

Stage 1: Marketing Rental Units

In order to effectively market rental units we must first understand what it means to effectively market a unit. Remember, an income producing property is only as valuable as the stability of its income stream. The goal therefore in marketing rental units is (a) to secure a qualified applicant (b) in a reasonable amount of time. In other words, having your phone ring off the hook with unqualified tenants might feel exciting but it won't accomplish the objective of getting the property stabilized with predictable income if the tenants aren't reliable. Secondly, if it takes an inordinate amount of time to secure a qualified tenant, the operating costs of the property can eat you alive. As such we need both: good tenants, quickly.

Marketing units is directly impacted by what's competing against your units. If you are attempting to rent a 2 bedroom, 2 bathroom apartment unit for $600 in a market where a 2 bedroom, 2 bathroom house rents for the same amount, you might find your marketing efforts frustrated by this alternative product. You must know how your product compares to available alternatives in the market in order to design an effective campaign. If you don't price your unit correctly, it will sit on the market forever. Your job is to figure out what that optimal number is so that you get the maximum possible rent in a reasonable marketing timeframe. There are websites that can help you do rental comparisons before putting your unit on the market. Checking with such websites before attempting to rent your unit could save you time and money.

You will need to learn how to balance between economy of language and accuracy of description. Most advertising channels charge based how much you say. The trick is to keep it brief while still hitting the key points.

Stage 2: Screening Prospective Tenants

Properly screening prospective tenants is one of the most important functions in property management because it directly impacts the cash flow of the property. Tenants can be persuasive and your job is to be as objective as possible when considering an application. The most important information on a typical tenant application form the following:

- Amount of income
- Source of income
- Previous residence
- Social security number

Income. The minimum income requirement should generally be a multiple of the rental payment. For example, if the rent is $700, the minimum income requirement might be $2100 (multiple of 3 times the rental income of $700). This requirement is to ensure that the applicant is not stretching too thin. When tenants make barely enough to afford rent the slightest unexpected event can cause them to default: speeding ticket, trip to the emergency room, or even a higher than expected phone bill.

Source of Income. The source of the income is just as important as the actual amount of income. Certain sources of income are not as stable as others. Unemployment benefits and child support payments could run out leaving the tenant with insufficient income.

Previous Residence. It is critical where possible to contact the tenant's previous landlord to determine whether the tenant was a good tenant. You do not want to inherit somebody else's problem.

Social Security Number. Credit checks and background checks can be a useful way to determine who you are dealing with. You may however be attempting to rent to a demographic that will often have issues with their credit. In such circumstances, holding out for the "A" credit tenant would be a bad idea. Instead, you need to actually examine the report to see what caused the derogatory credit marks. If, for example, the tenant had a serious illness that caused a mountain of medical bills, the tenant

might still be a perfectly conscientious tenant despite their bad credit history.

Stage 3: Executing Lease Agreements

Once the tenant is handed the keys and moves in, the relationship is locked in place. Tenancy has been established and a full-blown eviction would be required to remove the tenant if there is a problem and the tenant refuses to leave voluntarily. This means the execution of the lease and the granting of possession is a critical moment in the rental cycle.

Although standard lease agreements are readily available through a variety of sources (e.g., local association of real estate agents), you must decide whether there are specific provisions in the lease that you want to ensure are read and acknowledged by the tenant. Most tenants treat a lease as a boilerplate document and sign it without really reading it as long as the rental amount is what they agreed to pay. You, on the other hand, care that the tenant actually understands what they are obligating themselves to and intends to comply with the terms of the lease. For example, you might want to call attention to the policy towards late payments or pets by having the tenant initial that specific paragraph.

It is good practice to do a walkthrough of the unit with the tenant before handing over the keys. This way any issues or concerns the tenant has can be voiced and addressed before the commencement of the tenancy. You should conduct this walkthrough with a walkthrough checklist that the tenant can sign acknowledging that the condition of the unit is acceptable. This is important because tenants will often use problems with the unit as a justification for not paying rent especially early in the tenancy.

Make sure you and the tenant have a copy of the final executed lease so that in the event of a dispute you both can refer to the agreement.

Stage 4: Collecting Rent

Once the units of an income producing property are rented, the property is essentially stabilized. From this point, the primary activities involve collecting rent and responding to maintenance calls. Don't underestimate, however, the rent collection process.

Earlier I told the story of a seller of one of the apartment buildings I acquired early in my career having the unusual practice of collecting rent from whomever he happened to catch at home when he showed up. As you might imagine, the tenants in this building become so accustomed to periodically not paying rent, that rent collection for the first few months after I took over the building was challenging to say the least. Moral: your rent collection efforts will be in part set by the practices of the previous owner. You must be aware of these practices going in.

In addition, your success in collecting rent will largely be a function of how receptive you are to excuses. I bought a duplex where one of the tenants literally had an excuse every single month for why he couldn't pay rent. I told him that unfortunately the lender who had the mortgage on the property was not open to excuses for why I couldn't pay my mortgage. Therefore, I would not be open to excuses for why he couldn't pay rent. When I sold the property, I warned the buyer about this tenant. Several months later, I was checking the properties scheduled for foreclosure looking for deals and I saw that the duplex was already in default. I called the buyer and asked what happened. Sure enough, he had fallen for the tenant's excuses and was unable to carry the negative cash flow. Moral: your rent collections will be as successful as your willingness to enforce to the terms of the lease.

Couple final words of caution. Avoid accepting personal checks unless you are extremely confident in the reliability of the tenant. Insist on cashier's checks. Avoid payment plans for either the security deposit or the rent. They almost never work out. Once tenants get behind it is virtually impossible for them to catch up. You will generally either have to waive the past due amount or evict.

Stage 5: Responding to Maintenance Calls

Every landlord's nightmare is getting the call at 2:30am from a screaming tenant that the sewer system is backing up into their unit and spewing all over the carpet. To the extent you are not working with a professional property management company and you don't have employees who can handle this call, you will indeed be stressed out if you have to take this call personally. Fortunately, however, I can tell you that in all the years I have owned rental property I have found that this dreaded call happens extremely rarely and I have always been able to structure my operation such that I personally have never had to take this call.

The typical call is a leaking faucet, a leak in the roof or problem with the AC unit. In other words, they are not crises. They are normal problems that can be addressed within a reasonable timeframe. The key is building a team of reliable vendors that show up when they say they will and don't gouge. It is often beneficial to have someone on your team that has multiple skills so that several issues can be addressed in one trip. Invariably this will end up being less expensive than if you have to hire several different vendors.

Ironically, landscaping can actually be one of the more troublesome and expensive aspects of property management although it is not nearly as storied in the folklore of management nightmares. If you are managing properties with lawns you must ensure that you are working with a company that either will not allow a lawn to die or will warranty that if a lawn dies they will replace or restore it. A new lawn can be one of the most expensive things to replace on a rental property.

Finally, do not allow problems to linger if possible. Tenants become disgruntled quickly and that dissatisfaction will just as quickly translate to a refusal to pay either all or part of the rent whether it is actually justified or not. Once tenants get accustomed to not paying rent on time and in full, you are likely to have an ongoing problem. Fix what you are obligated to fix promptly and completely. Hire vendors who take pride in their work so that you do not have to revisit the same problem over and over. Tenants deserve a habitable environment if you expect timely rental payments.

Stage 6: Evicting Tenants

Your number one priority when evicting a tenant is to avoid direct confrontation. I have never met a tenant that believed they deserved to be evicted regardless of their payment history. Tenants don't show up in court and say, "Your honor I'm actually not sure why I'm contesting this suit because as I reflect on my payment history, the landlord is obviously justified in demanding possession of the unit." Quite the contrary, tenants almost always regard an eviction as a wholly unjustified and callous act of throwing their family on the streets.

Keeping this in mind, you will understand that not all tenants respond well to this exercise of your rights under the lease. Some tenants destroy the unit, other tenants make threats but the overwhelming majority of tenants will simply move on with their lives provided they are not given the opportunity to confront you in person.

Having said this DO NOT:

- Go to the property and introduce yourself as the owner
- Write the tenant a letter trying to explain your position
- Show up in court to have the last word

Hand the case over to a lawyer that specializes in eviction proceedings and allow the process to take its course.

TIP

Once you have decided to proceed with an eviction DO NOT accept any further payments of any amount

Stage 7: Turning Units

When tenants move out there is almost always work to be done. Even the most conscientious tenants cause wear and tear to a unit over time. The issue really is how much damage goes beyond normal wear and tear such that you are entitled to withhold part of the security deposit in order to address it.

The best way to measure the condition of the unit before and after the tenant's occupancy is (1) to make sure you take pictures of the unit prior to delivering the keys and (2) use a walkthrough checklist to make sure that the tenant acknowledges in writing the condition of the unit. The most common cause of dispute over the security deposit is the allegation on the part of the tenant that damage to the unit that is observed at the end of the tenancy existed prior to their possession.

The actual process of getting the unit back into marketable condition is not that different from any other renovation project except that it is helpful to work with a contractor who knows exactly what your typical budget is for turning a unit so that you don't have to negotiate from scratch every time a unit vacates.

Notes:

CHAPTER 8
EXIT STRATEGIES

The process of analyzing the merits of a particular property must always include an analysis of the possible exit strategies. In other words, you must understand what the entire game plan in for the property. Are you planning to flip the property as soon as possible? Are you planning to hold the property until you have restored it to optimal performance and then sell it? Or are you intending to hold it as part of your portfolio?

One of the most common mistakes of young investors is to assume that because they are buying a property to hold it for cash flow, they don't need an exit strategy. So let's dispel that myth right now. Several years ago I met with a billionaire who had made his money syndicating real estate deals in the 80's, lost most of his wealth by the early nineties and made most of it back by the time of our meeting in the mid-2000's. He told me that one of the worse things a real estate investor can become is a butterfly collector. I asked him what he meant and he said that a butterfly collector is a real estate investor who keeps properties not because they are true assets but because they want to marvel at all the properties they own like pretty butterflies in jars on a shelf.

Instead of collecting butterflies we must as investors know when a property has served its purpose in our portfolio. The problem of course is that if we don't have a realistic way of liquidating a property at the appropriate time in the investment cycle it could end up becoming an anchor that drags our net worth down.

Clearly the most common way to liquidate a property is to sell it to somebody else. This means that when you buy a property you must understand the factors that would determine whether a buyer would buy the property from you and what would motivate them to pay an amount that would enable you to accomplish your investment objectives. This means you need to consider:

- Any obstacles the buyer might encounter to obtaining financing
- Desirability of the property
- Impact of Cap Rate Movement

Financing

Most real estate transactions require third party financing. So it is critical to understand how lender underwriting guidelines might affect your ability to sell your property. After one of my seminars an attendee approached me and told me he was planning to buy a property with the help of an investor. The deal was as follows:

- He had the opportunity to acquire an ideally situated piece of land for $500,000. Even better, the owner of the land was willing to seller finance the transaction for 2 years so he wouldn't have to put up any money up front for the land.

- A friend of his was willing to put up the $300,000 necessary to construct an assisted living facility on the land.

- This would result in a total cost of $800,000 for the land and the facility and he was certain that upon completion the property would be worth at least $1,000,000. As you might imagine he was terrifically excited.

I asked what his exit strategy was and he replied, "Oh no, you wouldn't want to sell this property. The cash flow is going to be incredible. I am just going to refinance it after a year." So I asked him what loan-to-value he expected to get on the refinance loan and a puzzled look came over his face at which point I knew there was a problem.

Loan-to-value (LTV) refers to the amount a lender is willing to lend as a percentage of the total value of the property. For example, if the property is worth $1,000,000 and the lender's LTV is 70% on commercial property, then the lender is willing to make a maximum of a $700,000 loan on this property assuming all of the lender's other underwriting guidelines are met.

With that understanding let's return to this assisted living facility transaction. Regardless of how long you would like to hold the property, the investor will typically want the investment capital back plus the expected return on investment after a year or two.

So here's what we have:

- Value: $1,000,000
- LTV: 70%
- Maximum Loan Amount: $700,000
- Invested Capital: $800,000
- Shortfall: -$100,000 (for the sake of simplicity I am ignoring loan fees which would make the shortfall slightly larger)

So I asked the gentleman, "Given these numbers, do you have the $100,000 to pay the investor plus the expected return?" He shook his head looking a little crestfallen at this point. "Then how," I continued, "do you plan to keep the property and return the investors capital?" "I just hadn't thought of that," he confessed.

I cannot tell you how many conversations I have had like this. Even the most thorough investors often forget to think through the end game for the property. The reason this happens is because great deals are hard to find, so when we find them, it is easy to get carried away in the excitement of getting the deal under contract. There is nothing wrong with being excited about finding deals. In fact, we should get excited if we are passionate about the business. There is nothing wrong with pushing to get what appears to be a great deal under contract. But, the point of the due diligence period is to temper that excitement with sober analysis. That analysis must include a close examination of your exit strategies.

Marketability of the Property

The viability of your exit strategy also depends on the backend marketability of the property. This point can also be illustrated with an anecdote. Another gentleman approached me at the end of one of my presentations and told me that he had the opportunity to buy an old hotel in his hometown at an incredibly low price. They were "giving it away" as he put it. His plan was to convert this hotel into a chic live/work studios. The budget for this conversion was significant but he was convinced that the amount he could sell each unit for would generate a substantial profit on the overall transaction.

"Interesting," I said. Tell me about this town. "Well it's a wonderful little small family town. You know, the kind of town where everybody says hi to you as you walk down the street," he said glowing with pride. Immediately I could tell he hadn't thought this transaction all the way through. The mesmerizingly low acquisition price had blinded his long-term vision. Trying not to be a naysayer I asked, "what demographic buys live/work studios". "Young professionals, artist types," he answered. "Is there a strong young professional or artistic community in this town?" "No, most of those types go off to the nearest big city center." At that moment he realized he had a problem:

1. He was creating a product for which there was no real demand.
2. He was creating a product for which there were no comparable sales to use as a basis for pricing the product.
3. He was positioning himself to be the owner of a property that he might end up stuck with because nobody else in the community is interested in owning a building full of live/work studios.

The flaw with this transaction seems obvious under the bright light of objective reflection. But at the moment that someone offers you something that on its face appears to be a great deal, it is easy to miss the obvious unless you force yourself to go through this process of exit strategy analysis.

Impact of Cap Rate Changes

One of the biggest impacts on your ability to dispose of a property in a way that ensures you accomplish your original objectives is movement in market cap rates. This point can best be made with the following numerical example.

- Assume you purchase a property with an NOI of $100,000 annually.
- You pay $1,250,000 because you are buying the property at an 8% cap rate.
- You immediately start filling vacancies such that after two years you have gotten the NOI up to $120,000
- During that two-year period market cap rates in the area where the property was situated deteriorated to 10%.

If your plan was to sell the property after stabilizing it, you would have a problem. Even though you have increased the rents, this property at current cap rates would only be worth only $1,200,000. So you would have spent two years worth of time, energy and money on a property that is now worth less than you paid for it.

The point of this example is that cap rate movement has a significant impact on the value of income producing property. You must have a sense of what is happening with cap rate trends in the markets you are interested in as part of your overall analysis. You can get current cap rate information from local commercial brokers. Cap rate trends, on the hand, is generally provided by economists that study the market in question.

Obviously, nobody has the proverbial crystal ball but by subscribing to market reports by reputable economists you can begin to get an idea of some of the factors that affect cap rates.

Tax Considerations

If planned properly, investment properties can be disposed of in a way that minimizes the tax implications of the sale. Tax considerations are important because the tax consequences of selling a property that has been held for a significant amount time can be significant.

One of the most common ways to mitigate tax consequences when selling investment properties is to do a tax deferred exchange. Although tax strategies are beyond the scope of this course, it is important to have a general sense of they fit into overall exit strategy analysis. As the name implies, a tax deferred exchange doesn't eliminate taxes, it defers tax liability by essentially shifting the capital gain to another property.

The following example illustrates the process.

- Assume that you purchased a property for $500,000 with a loan of $400,000 and $100,000 downpayment
- After five years the property has appreciated such that it is now worth $700,000. You have been making interest only payments so your loan is still $400,000.
- If you sold the property, you would recover your $100,000 downpayment and receive an additional $200,000 of capital gain.
- But let's assume there is a similar investment property that you would like to buy for $700,000. It's a fantastic deal because it is a bank-owned property that is really worth $850,000. Instead of being taxed on the $200,000. You could use the tax deferment process to buy this new property with a $400,000 loan. Put a downpayment of $300,000 and you would end up owning an $850,000 property with $450,000 of equity and pay no taxes on the sale.

It is precisely for this reason that your core team should always include a competent tax advisor that is knowledgeable specifically about tax planning in the real estate context.

Notes:

Chapter 9
Building Your Team

If you are going to offer value when you negotiate, you will need to assemble a team that is reliable, professional and competent. This team should consist at the very least of the following members:

1. A contractor
2. A property manager
3. A lawyer
4. A real estate professional
5. A CPA

I will assume for purposes of this discussion that you are not in a position to have these team members in-house initially and, therefore, you will be dealing with third parties. The strength of your team will depend on your leadership. All team members must understand that even though they are not on the same payroll you are still building a company together, a company that has a mission statement just like any other company and a company that abides by certain principles and standards.

In order to instill that common sense of purpose you must first determine what those principles are and the standards you are seeking to hold yourself and your team members accountable to. Things like

1. Fair dealing
2. Punctuality
3. Good workmanship

Your standards and principles will govern both how you deal with each other as well as others. The discussion below will give you a sense for the kinds of questions you should be asking them. Some of the questions seem playful but every question is based on a real experience I have had.

Top Five Interview Questions For Contractors

1. Why are you so well dressed?

    a. [If contractors dress too well that means that they do not do any of their own work and they are expensive]

2. Where is your truck?

    a. [If contractors don't have a vehicle that can haul material that means they don't haul material. If they have a luxury sedan that doesn't haul material, see first question]

3. How old is your truck?

    a. [I cannot tell you how many times I have seen a job stall because the contractor had car problems and couldn't consistently get to the job site. And if a contractor asks you for gas money, run. (I didn't the first time I got that request and ended up paying for a lot more than gas)]

4. Do you have insurance?

    a. [Contractors need to have their own liability insurance and workmen's comp insurance because they and their crews are involved in activities that can pose a significant risk of injury.]

5. Are YOU licensed?

    a. ["What's your license number?" is the wrong question because contractors are notorious for using other people's license—their cousin's, their uncle's, their friend's. The right question is "What's YOUR license number?"]

Top Five Interview Questions For Property Managers

1. Do you get homesick?

    a. [In order to turn around some buildings the property manager might actually have to live onsite for a while especially if the building is out of town.]

2. What areas do you work in?

    a. [Some property managers are very picky about where they work and you cannot always decide where you find your next deal.]

3. How are your anger management skills?

    a. [Unfortunately, property managers have to deal with confrontation. Not all tenants will play nice and many tenants will push you to the limits of your patience. A good property manager has to be tough but not lose it. I have seen property managers lose it—not pretty]

4. Are you handy?

    a. [If you have to call the contractor for every leaky faucet, that could get expensive. It sometimes helps if the property manager can fix minor issues.]

5. Are your fingers sticky?

    a. [Property managers whether you like or not end up handling a lot of cash.]

Top Five Interview Questions For Lawyers

1. How much do you cost?

2. No seriously, how much do you really cost?

3. Are you a repressed business person?

   a. [You want a lawyer who secretly aspires to be a business person. Because they will be focused on helping get deals done as opposed to pointing out all the reasons you should not do a deal.]

4. What's your IQ?

   a. [If a lawyer actually knows the answer to this question, there is reason to be concerned. Seriously, you don't want a lawyer who is overly intellectual. High intellectual lawyers are great if you are filing a patent application but if you are trying to structure a real estate deal what you want is good business sense and even more common sense.]

5. Have you ever worked at a big firm?

   a. [Transactional attorneys that got their start at a big law firm can often bring very valuable knowledge to the table about how to structure deals because they have typically seen how the best of the best put deals together.]

Top Five Interview Questions For Real Estate Professionals

1. Why did you get your license?

    a. [The wrong answer to this question is "because I couldn't figure out what else to do". The right answer to this question "because I have always been passionate about real estate"]

2. Do you own any property?

    a. [If a car sales person were taking the bus, you'd be a little suspicious right? Similarly, if a real estate agent or a mortgage broker is going to be helping you put deals together and they have never purchased a property themselves you need to know why because there are a lot of things you learn when you personally have been involved in a transaction that you cannot learn simply by representing someone else.]

3. What market indicators do you track?

    a. [A real estate professional who is not interested in what is happening in the market is lazy.]

4. How do you market yourself?

    a. [A real estate professional who does not have a well articulated marketing strategy is lazy. In today's market they should probably also have a personalized website.]

5. How quickly do you return phone calls?

    a. [There is rarely a time where the failure of a contractor or property manager to return you call instantly has serious consequences. But the failure of a real estate professional to return a phone call to write up an offer on a property you stumbled across could cost you the deal.]

Top Five Interview Questions For a Tax Advisor

1. Do you specialize in real estate?

    a. [The wrong answer to this question is "tax law is tax law". The tax code is long and complicated. The more specialized the person is, the more likely they are to help you achieve a comprehensive and effective tax planning strategy.]

2. Do you work with closely held companies?

    a. [The entity you choose for the various aspects of your real estate investment business (e.g., property management) can have significant tax implications. A tax advisor that can help you understand these tax implications is critical.]

3. How aggressive are you?

    a. [The wrong answer to this question is "I'm really good at wiping out tax liability but my clients generally don't worry about how I do it." You want to work with someone who is able to get you the benefits you are legally entitled to but not someone who is going to "bend" the rules.]

4. Are you familiar with repatriation of money?

    a. [If you interested in investing in US real estate, you will need to work with a tax advisor who is familiar with the tax implications of bringing the profits from your US investments back into Canada]

5. Do you just prepare taxes or do you help build businesses?

    a. [You want to work with someone who is going to help you think strategically about the growth path of your business, not just someone who knows how to prepare a tax return].

Conclusion.

Real estate has taken countless aspiring entrepreneurs from humble beginnings to impressive fortunes. In fact, I truly believe that few entrepreneurial paths pay such high dividends so reliable. However, there are no get rich quick schemes in real estate. You must develop a systematic plan that you will execute with discipline over time. This is a business not a hobby. You must approach it with the same rigor as you would approach any other business that has the potential to yield significant profits.

Overzealousness can obliterate significant net worth in short order. Due your diligence on every deal. Don't get lazy. Be selective in choosing your deals. Remember, there are no deals of the century. There are only deals that are profitable and deals that are not. Be prepared to walk from a deal if something gives you cause for concern because another opportunity will present itself sooner that you might imagine.

Most importantly, have fun. Part of what makes real estate so amazing is that you can buy investments that make substantial profits while serving as incredible vacation homes. So of my most profitable deals have been vacation properties in breathtaking communities with private lakes and golf courses. The best real estate investors love the business. They search hungrily and tirelessly for the next deal. It's not work. It's a passion.