MAKE MONEY

with

AFFORDABLE APARTMENT BUILDINGS AND COMMERCIAL PROPERTIES

SECOND EDITION

GARY W. ELDRED, PhD

WILEY

John Wiley & Sons, Inc.

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Gary W. Eldred, Ph.D.

INTRODUCTION

How to Start

You've often heard it said, "It takes money to make money." Not true. To make money with commercial and investment properties you need analytical abilities, an entrepreneurial spirit, and market savvy. When you display these virtues, the money finds you.

In the world of investment real estate, people who find and put together deals outearn the far larger number of people who only bring money to the table. In the field of commercial and apartment properties, ideas trump capital. Even better, the capital required may total far less than you think. You can buy such properties for prices less than $100,000—tens of thousands of properties are available for under $500,000.

Getting started with commercial/investment properties is far easier than most people believe. But the real advantage results as you learn and play the game. Unlike investments in houses and condos, in this arena the rewards can quickly jump into the millions. To become a player, you need only develop your analytical and entrepreneurial talents.

Develop Your Analytical Abilities

Any reasonably diligent person can estimate the market value of a house by looking at a half dozen similar houses in the same

Outsmart your competitors.

neighborhood that have recently sold. In contrast, valuing investment and commercial properties requires specialized skills. Rarely will you find two income properties that match each other as closely as houses do. With income properties, you learn to pay attention to details and numbers.

That's why this book goes beyond the cliches and simplistic prescriptions of most other books on real estate. Here, you learn to judge market values, cash flows, income statements, property features, and locations. You will see how to use the same techniques professional investors use. You will discover with critical *and* opportunistic eyes. You will understand how to judge the strength of the area's economy that supports property values, rent levels, and appreciation.

Once you think and work with these concepts and techniques, you can easily find and identify those properties that are almost guaranteed to give you strong returns.

Develop an Entrepreneurial Spirit

In the popular mind, the term *entrepreneur* means "risk taker." Don't believe it. Through analytic and opportunistic thinking, entrepreneurs decrease risk while they magnify their gains. To achieve this result, entrepreneurs search to find a better way; entrepreneurs develop inquisitive habits of mind. They question. They experiment. They open their minds and remain alert to new information, new opportunities.

Learn to think like an entrepreneur.

Uncommon, Yet Essential

This entrepreneurial spirit doesn't come easily to most people. You must work to nurture it. Whenever you look at a property, the

entrepreneurial spirit should urge you to blend critical judgment with vision. Rather than critique what's wrong, brainstorm profitable possibilities. Rather than accept clichéd advice or so-called standard operating procedures, entrepreneurs ask why or why not.

Now think: Do you block your entrepreneurial abilities? Do you fill your day with nonproductive complaints, gripes, and frustration? Do you quickly pass by new ideas and different ways of seeing or doing? Do you believe that you pretty much know all you need to know? Or do you eagerly try to add to your base of knowledge and experiences?

Eliminate your self-denying self-talk.

In his thought-provoking book *What to Say When You Talk to Your Self* (Pocket Books, 1982), Shad Helmstetter points to many habits of speech that block people from achieving their goals. This nationally prominent psychologist shows how most of us in one way or another build "walls of negative self-talk" that unconsciously and severely limit what we do and what we're willing to try.

Listen to your language. Invite critique from others. What patterns of speech, what words and phrases, what limiting beliefs do others notice you using? And that biggest block to creating wealth, do you procrastinate? (See Figure I.1.)

Entrepreneurs Create Value for Themselves and Their Customers (a.k.a. Tenants)

From this book, you will broaden your imagination. You will multiply and enhance your investment possibilities. Most importantly, you will learn a system of strategic thinking to guide you toward profitable plans of action.

Your profitable property operations and improvements will grow from your enthusiasm and desire to provide targeted tenants (customers) with an outstanding value proposition—a value

Someday I should write a list
Of all the deals that I have missed;
Bonanzas that were in my grip—
I watched them through my fingers slip;
The windfalls which I should have
bought
Were lost because I overthought.
I thought of this, I thought of that,
I could have sworn I smelled a rat,
And while I thought things over twice,
Another grabbed them at the price.
It seems I always hesitate,
Then make my mind up much too late.
A very cautious man am I
And that is why I wait to buy.

When tracks rose high on Sixth
and Third,
The price asked, I felt, was absurd;
Those blockfronts—bleak and black
with soot—
Were priced at thirty bucks a foot!
I wouldn't even make a bid,
But others did—yes, others did!
When Tucson was cheap desert land,
I could have had a heap of sand;
When Phoenix was the place to buy,
I thought the climate was too dry;
"Invest in Dallas—that's the spot!"
My sixth sense warned me I should not.
A very prudent man am I
And that is why I wait to buy.

How Nassau and how Suffolk grew!
North Jersey! Staten Island, too!
When others culled these
sprawling farms
And welcomed deals with open arms . . .
A corner here, ten acres there,
Compounding values year by year,
I chose to think and as I thought,
They bought the deals I should have
bought.
The golden chances I had then
Are lost and will not come again.
Today I cannot be enticed
For everything's so overpriced.
The deals of yesteryear are dead;
The market's soft—and so's my head.

Last night I had a fearful dream,
I know I wakened with a scream:
Some Indians approached my bed—
For trinkets on the barrelhead
(In dollar bills worth twenty-four
And nothing less and nothing more)
They'd sell Manhattan Isle to me.
The most I'd go was twenty-three.
The redmen scowled: "Not on a bet!"
And sold to Peter Minuit.

At times a teardrop drowns my eye
For deals I had, but did not buy;
And now life's saddest words I pen—
"IF ONLY I'D INVESTED THEN!"

—Anonymous

The moral: Don't wait to buy real estate. Buy real estate and wait.

Figure I.1 The Procrastinator's Lament.

proposition that these selected tenants eagerly prefer over those value propositions offered by other competing property owners.

Good strategy begins with wanting to do good. It's as much emotional (passion) as it is intellectual. It makes no difference whether you offer offices, retail, or apartments. Think foremost about what your intended tenants value most in terms of property features, amenities, services, and lease terms and clauses.

Market Savvy: Systematic Strategic Thinking

Try this experiment: Talk with run-of-the-mill property managers, leasing agents, property owners, and investors. Ask them how they come up with a market strategy that maximizes their cash flows as well as their long-term property values. Their answers, at best, will combine random degrees of experience, seat-of-the-pants judgment, and creative insight. Yes, at most times and in most markets, investors who approach strategy in this offhand way do succeed. Steady rent increases, property appreciation, and a paid-off mortgage usually yield excellent long-term returns.

But these investors don't make nearly as much money as they could. They suffer more headaches and hassles than necessary. And for many, when storms hit, their boat capsizes. Why do I emphasize these points? Because for more than 20 years, I've worked as a market and financial consultant to homebuilders, developers, investors, and realty firms. In addition, I've bought, renovated, managed, and sold dozens of investment properties for my own account (with and without partners).

Do well by doing good.

In all of this experience, I've never seen a property where profits could not be increased through better, more systematic approaches to strategy and execution. The evidence I've accumulated proves that you will multiply returns and alleviate risks when you systematically

organize your thinking, data gathering, and operating plans. As you adopt this strategic approach, you will see how to blend market study with systematic, goal-oriented thinking to outperform competing property owners and investors whether you face good times or bad.

If market study and strategic thinking sound like work, you're right—up to a point. But after you set up your system and develop a plan to keep it current, your day-to-day efforts will diminish and your wealth will grow. As with all professional learning, a relatively small amount of effort up front pays big dividends over time. You can easily find much of the market, economic, and property data that you need. Government agencies, Realtors, property management firms, utility companies, and other sources routinely collect and publish valuable information about real estate and local economic trends.

Earn superior returns through strategic marketing.

And in the end, it is you who will decide how much fact-finding to include in your strategy making. On some consulting assignments, I've put in three months full-time. But even if you choose to invest just three days to accumulate market data, the returns from your investments will show a marked improvement. Your entrepreneurial spirit, market savvy, and strategic thinking will soar your performance—above your competitors who fly low by the seat of their pants.

Stephen Covey emphasizes, "Begin with the end in mind." Amen! To maximize returns and anticipate/alleviate risks, think through your market and financial strategy for each property you own—before you buy it. Then execute, monitor, adapt, and improve (in Covey's terms—"sharpen the saw"). With this entrepreneurial action plan, you will prosper with property.

CHAPTER 1

Profit with Commercial and Multifamily Properties

Increasingly, small investors are beginning to explore the wealth-building opportunities offered by affordable commercial and multifamily properties. Because such properties provide many advantages, I encourage you to get into this lucrative field.

Advantages of Commercial and Multifamily Properties

Most would-be real estate investors already own a personal residence, so buying a single-family house to rent out merely repeats a familiar purchase process. In contrast, small investors usually steer clear of commercial and multifamily investments. Most likely, they fear that such properties cost too much or require extensive expertise. Neither of these perceived roadblocks is true.

In fact, at the age of 21, I began investing in multifamily properties with a 5-unit property, followed by a 7-unit property, and next added 10 units to my portfolio. If I could manage to buy and operate such properties, so can you. Neither beginning nor seasoned single-family residence (SFR) investors should fear investing in commercial properties or apartment buildings. A physician in Atlanta recently asked me for advice. I suggested that he look for a

4- to 12-unit apartment building or perhaps a small office building or shopping center rather than the single-family houses that he was considering. I set forth these reasons:

- Cost of acquisition
- Cash flows relative to price
- Search time
- Management
- Tax-free, trade-up potential
- Owner and/or partner financing
- Possibilities for creating value

Cost of Acquisition

The median price of a single-family house in the United States now stands at $225,000. In higher-priced areas such as San Diego, San Francisco, Boston, New York, and Washington, D.C., the median price of a single-family house exceeds $500,000. Unless you invest in less desirable neighborhoods—and even there, house prices can still seem out of reach, such as in East Palo Alto, California, or Chicago Southside—single-family investing becomes too costly for most investors of average means.

Single-family rentals often yield negative cash flows.

By "too costly," I do not refer only to price. Rather, I refer to price relative to rent collections. In San Diego, for example, a $500,000 house might generate no more than $2,000 a month in rents. Even in my (relatively) low-cost city in Florida, a $250,000 SFR typically rents for $1,000 to $1,300 a month. Put 30 or 40 percent down and these properties still throw off negative cash flows. (New investors feel like they are being eaten by alligators.)

Homebuyers, too, are realizing the advantages of owning income properties. Owner-occupied duplexes, triplexes, and fourplexes are attracting renewed interest. Individuals or families

Affordable apartment buildings appeal to homebuyers and investors.

who cannot afford the monthly payments on a $350,000 house find that they can afford a $500,000 or $600,000 fourplex because their rent collections go a long way toward paying their principal, interest, property taxes, and property insurance (PITI).

When I talk with homebuyers who are priced out of their preferred neighborhoods, I tell them to look for a small apartment building. Buy it. Use rent collections to help meet monthly expenses. Create value through improvements and then sell or trade up in a few years. This is the same advice I give to real estate investors.

Given their lower per unit prices (relative to single-family houses), many income properties offer you a more affordable entry into real estate.

Cash Flows Relative to Price

If you think commercial and multifamily properties cost too much, go to www.loopnet.com. You'll find thousands of retail, office, and apartment buildings priced at less than $500,000. How about a retail (hard corner) building in Odessa, Texas, leased triple-net (tenant pays all expenses) to a prosperous local ice cream business? The price: $125,000. The net operating income (NOI): $11,245. Walgreens and other national brand retailers have located close by in this emerging growth area.

Or if you want a real bargain-basement price, how about a $39,000 duplex with long-term tenants who pay (in total) rents of $930 a month with a $7,000 a year NOI.

Yes, these two properties sit near the low end of the commercial and multifamily price range, but my point is that virtually anyone can invest in commercial or multifamily properties. Moving up the price scale, you can buy a building leased to Payless Shoes for a little over $300,000. That property yields an NOI of $32,000 a year. Or perhaps a well-kept 10-unit apartment building in a good

area of Omaha for just $349,000. Its NOI exceeds $27,000 per year. In Athens, Georgia, near the University of Georgia campus, and just across the street from the newly proposed medical school, you can buy an 8-unit building (legally set up as condominiums for future sale to individuals) for $630,000. Current NOI totals $53,000 per year.

If you prefer offices, a seven-year-old Athens, Georgia, building net leased to a single tenant can be bought for around $325,000. Financed with an 80 percent loan to value (LTV) mortgage gives you a positive cash-on-cash yield of 10 percent.

We need not go further here because you can review tens of thousands of listings yourself at loopnet.com and other property-for-sale web sites. But the examples above illustrate my point. For prices lower than average California single-family houses, you can own commercial and multifamily properties that not only yield positive cash flows at 80 percent LTV (or higher) but they also offer potential for appreciation and value-add improvements and/or market repositioning.

Expect Yields to Fall in the Future Today, many affordable investment properties generate positive cash flows. Will this situation continue? I don't think so, at least not with 20 percent (or lower) down payments.

As boomers fret about the source and adequacy of their retirement incomes, increasing numbers will recognize the advantages of income properties. As more investors search for cash flow properties, they will bid prices up further. Although over time rent levels will continue to inflate, property prices will inflate at even greater rates. Relative to property prices, cash flows (rent collections) will not keep pace. We can see this trend in New York, London, Sydney, Dubai, and San Francisco. In these and other high-priced locations, speculators in appreciation potential have pushed most cash flow investors out of the market.

LoopNet has listed a six-unit property in San Francisco for $1.2 million. Rent collections for this property total just $7,200 a month. This price-rent relationship (the gross rent multiplier)

came in at 166. With 20 percent down, the rents would barely cover the mortgage payments (debt service).

Either investors must come up with a higher down payment or go out-of-pocket each month to pay for property taxes, insurance, maintenance, and repairs. An all-cash purchase of this property would have netted an annual yield of just 4.7 percent (not counting appreciation, which, of course, is where the buyers would hope to make their money).

Too much money is chasing too few cash flow investments.

Fortunately, many commercial and multifamily properties still offer reasonable cash flows *and* potential for appreciation. But don't wait. Given that government and corporate bond interest rates offer low returns and yields from stock dividends average less than 2 percent, income properties stand superior to all other popular investments. Yet, with too much money chasing too few good cash flow investments, you must act now. Absent general economic collapse, five years from now the selling prices of small income properties will have climbed significantly, and positive cash flows (under historically normal terms of financing) will be found in fewer and fewer locations. Affordability will diminish.

What Yields Are Reasonable? Throughout the 1990s, many stock market investors received capital gains of 12 to 20 percent a year. By the turn of the century, surveys revealed that investors believed that such high returns would continue long into the future.

As people now realize, these grandiose expectations defied reality. Because the U.S. economy grows (on average) just 2 to 4 percent a year, it will prove impossible for stock prices to consistently grow three or four times faster than GDP. Stock hypesters have now muted their rhetoric. Even that great bull Jeremy Siegel (*Stocks for the Long Run,* McGraw-Hill, 3rd ed., 2002) tells stock investors to prepare for stock market returns of no better than 7 percent a year for at least the next decade. And that 7 percent is before deductions for brokerage fees, mutual fund expenses, and income taxes.

As of early 2008, the DJIA had barely passed its year 2000 peak. Total DJIA returns since 2000 have averaged less than 5 percent a year—actually less total yield than government bonds.

Implications for Real Estate With dividend yields (positive cash flows) on stocks of less than 2 percent a year and total pretax, preexpense returns of 5 to 7 percent, investors need higher yields. Yet, only income properties offer investors those double-digit (total) returns that stocks experienced for one brief and exceptional moment in history.

Most people fail to recognize this opportunity. They cling to the false hope that stocks will rebound and replay their glory days. Others have pushed money into risky hedge funds or they merely sit on the sidelines and hold their cash in low-return CDs and money market funds.

Another problem: Those headlines that scream every day about crashing home values do not distinguish the investment property market from the spec-built home market. Fear due to lack of information immobilizes many potential property investors.

This mass misunderstanding and misallocation of investment dollars won't persist. Every few weeks, I see financial planners quoted in personal finance magazines fretting over the broken nest egg dilemma.

Property prices will go up as investors search for inflation-protected retirement income.

The *broken nest egg* refers to the fact that people who fill their retirement portfolios with stocks won't receive enough income from those stocks to pay their retirement living expenses. A million-dollar diversified stock portfolio pays (under current yields) about $12,000 to $20,000 per year, depending on the specific stock holdings. To survive at above subsistence levels, most so-called stock market retirees must draw down their savings (i.e., break their nest eggs).

But since these retirees do not know how many years they will survive after they retire, they cannot reasonably estimate a safe withdrawal rate. Their dilemma is to live well and face the risk

of running out of money or live like misers and forgo the material pleasures that a lifetime of saving and investing was supposed to bring.

Twenty years ago, fewer than 10 million Americans seriously saved and invested for retirement, for their kids' college educations, and for other longer-term financial goals. Today, that number has grown to more than 50 million people.

It doesn't take Einstein to figure out that the middle class has joined the moneyed class in pursuit of high-yield investments. Cash yields must continue to fall. It defies reason to believe that 50 million Americans can find safe investments that will yield total returns of 10 or 12 percent a year. We all can't get rich with stocks and bonds.

All investment returns yields will continue to fall.

This is why I urge you to start investing in income property—now. Even though cash flow returns today don't look as good as they did 5 or 10 years ago, they look better today than they will look 5 or 10 years into the future. The number of investors who want high yields has grown much faster than the capacity of the economy to generate high investment returns. Mathematically, a majority of investors must end up disappointed.

Search Time

Compared to single-family houses, you can build wealth with investment properties with less search time. Even in high-cost areas, a $5 million or $10 million portfolio of houses would (or at least should) include at least 15 to 20 properties. In lower-priced areas, a portfolio of this amount might include 50 properties. To buy that many houses would require several thousand hours to find houses, look at houses, evaluate neighborhoods, negotiate purchase contracts, and apply for loans.

With income properties, you can work up to a $5 million or $10 million portfolio with as few as four to eight acquisitions. Even

Build unlimited wealth with income properties, yet allocate less time and effort.

if each deal takes three to four times as long to complete as one single-family purchase, you still save search time. As you move up to a $20 million, $30 million, or $50 million portfolio of properties (should you plan to grow that wealthy), a comparable sum devoted to single-family houses would prove impossible to acquire and manage. If you want a life (not a job), investment properties provide more return for each hour spent in property acquisitions and negotiations.

Management

If you own 15 or 20 houses, you own 15 or 20 roofs, electrical and plumbing systems, and yards to oversee. If you own two or three investment properties instead, you reduce the number of components that will, at some point, need attention. Although maintaining an investment property can cost more per building, it costs less per unit, in terms of both dollars and time.

If you choose, you can also own net lease investment properties. *Net lease* office buildings, shopping centers, and free-standing retail stores shift responsibility (in varying degrees, depending on specific lease terms) for maintenance, repairs, property taxes, and insurance to the tenants.

You can operate multifamily apartment buildings under a master lease (likewise for office and retail). With a master lease, one master lessee (tenant) pays you and assumes responsibility for leasing out individual units (spaces) and paying expenses.

As another alternative, employ an on-site manager who attends to day-to-day concerns that arise. Compensate your on-site manager(s) with a nominal amount of rent reduction. On-site people can perform some maintenance and repairs, address most tenant problems or concerns, and prepare and lease vacancies as they occur.

Trade Up Tax Free

To build wealth avoid paying taxes. For owners of investment properties, the Internal Revenue Code offers a generous advantage. As you acquire larger and larger properties, the law permits you to pyramid your wealth-building tax free through a Section 1031 tax-deferred exchange.

When you *sell* a property, you pay a tax on your capital gain. The amount you can reinvest in a larger property is reduced by the amount of taxes owed. With a Section 1031 exchange, you preserve your gain, and your total accumulated equity counts toward your down payment on the larger property. No income taxes are due.

Never pay tax on capital gains.

Exchanges Don't Require Two-Way Trades Because many real estate investors do not understand tax-free exchanges, they believe that to use this tax benefit, they must find a seller who will accept one or more of their currently owned properties in a direct trade. Although this possibility represents one way to complete a tax-free exchange, it does not represent the most commonly used exchange technique. Most exchanges involve at least three investors.

The Three-Party Exchange Three-party exchanges outnumber two-party trade-in exchanges because it's usually difficult to find someone who owns a property you want who will accept the property you plan to trade. It's sometimes possible to persuade an unwilling seller to accept your property in trade. But to do so may cause you to waste negotiating capital that you could otherwise devote to issues such as a lower price or owner-will-carry (OWC) financing.

Exchanges usually involve several property owners who simultaneously buy and sell.

Instead, most real estate pros arrange a three-party exchange through the following three steps: (1) Locate a buyer for the property you want to trade; (2) locate a property you

want to buy; and (3) set up an escrow whereby you deed your property to your buyer, the buyer pays your seller, and your seller conveys that property to you. No property has really been exchanged for another property.

Exchanges Are Complex but Easy Most transactions that involve federal tax laws activate a web of rules. Section 1031 exchanges prove no exception. However, even though exchange rules are complex, exchange transactions are relatively easy to carry out when you work with a tax pro who is experienced in administering tax-free exchanges.

The fees (including attorney and escrow) for conducting an exchange should range between $750 and $2,000.

Caveat: A majority of certified public accountants (CPAs) and real estate attorneys know little about Section 1031 exchanges. Unless your accountant or lawyer has mastered this area of law, find someone else who has this expertise. If you live in at least a midsized city, there's probably an exchange club whose members include investors and commercial real estate brokers who can recommend exchange experts.

Upward exchanges do not result in taxable gains.

Are Tax-Free Exchanges Really Tax Free? Some people quibble over the term *tax-free exchange.* They say that an exchange doesn't eliminate taxes but only defers payment to a later date. This view errs in five possible ways:

1. The exchange itself is tax free if you follow the rules.
2. Whether you pay taxes at a later date depends on how you divest yourself of the property. If you hold it until death, the property passes into your estate free of capital gains taxes.
3. As another alternative, you can arrange a sale in a later year in which you have tax losses that you can use to offset the amount of your capital gain.

4. You can withdraw your equity through a tax-free cash-out refinance.
5. If we get lucky, the United States may adopt the policies of many other countries and abolish taxes on capital gains.

Exchanges eliminate capital gains in the year you dispose of an income property by trading up. Whether you pay in future years depends on how wisely you develop your tax-avoidance strategies and on future tax laws. By exchanging, you eliminate a definite tax liability in the year of sale and accept an uncertain and contingent tax liability. That's a tax trade-off you should make.

Single-Family Houses Technically, you can use a Section 1031 tax-deferred exchange to avoid taxes when you acquire more expensive investment houses or to trade up from a single-family house to a multi-unit property. Though a practical matter, owners of commercial and multifamily properties use this technique more often than do owners of rental houses. Experienced investors readily enter into such agreements and are well acquainted with the 1031 advantages. Owners of single-family residences are less likely to understand exchanges and tend to reject the unfamiliar.

You can also trade up single-family rental houses and condos tax free.

Nevertheless, if you own or plan to own single-family rental houses, explore the possible use of Section 1031 exchanges. To move up from one or more single-family residences to multi-unit buildings, structure your transaction to avoid those equity-slicing taxes on capital gains.

Owner Will Carry Financing (OWC)

In the world of real estate, owner-will-carry (OWC) financing often beats bank financing. Generally, owners structure deals with less red tape; easier qualifying, more flexible (creative) terms; and

Owners often offer seller-assisted financing to investors.

lower closing costs. Owner-sellers frequently accept lower down payments than banks. Although some sellers of single-family houses finance their buyers, the practice is widely accepted with commercial and multifamily investments. Many of my acquisitions have involved at least some seller financing.

Yet, as the late real estate investor and columnist Robert Bruss pointed out, many owners don't volunteer OWC financing. To get it, include OWC as part of your purchase offer. Then explain why it makes sense from the seller's point of view. OWC often helps you close deals with financing terms that would never pass muster with a bank underwriter.

Possibilities to Create Value

Although you can create value through improvements of single-family houses, your possibilities for doing so increase substantially with investment properties. With single-family houses, you bid against homebuyers. Because most homebuyers don't factor a profit margin into their purchase offers, they pay too much for properties in need of work.

Professionals dominate the investment property market. Investors run the numbers. Without profit potential, they turn down the deal. Bidding wars and overpaying result less frequently. To attract a buyer, sellers of investment properties must price their properties (or give other incentives) to persuade investors they can earn a profit.

Income properties multiply your opportunities to create value.

Types of Improvements With single-family houses, tight zoning laws, homeowners association (HOA) rules, the character of the neighborhood, and the prices of nearby houses all conspire to limit your upside potential. With multi-unit properties, value relates directly to

the amount of net income the property produces. Anything you can do to boost net income boosts the value of the property. Because investment properties are typically regulated by less restrictive zoning laws, you typically enjoy a wide variety of entrepreneurial, profit-generating possibilities.

Moreover, strategic marketing and management count more toward creating value for investment properties vis-à-vis single-family houses. A house is worth what a house is worth. Strategy plays a less important role. The great majority of people plan to live in the house they buy, not rent it out. With investment properties, strategy controls operating costs, tenant satisfaction, tenant turnover, and rent collections. Together, these and other decisions influence the cash flows that the income property produces and, correspondingly, its value.

Even better (at least in terms of your opportunities), most owners of small income properties manage their buildings poorly. Verify this fact for yourself. Look at some properties. Talk with tenants. You'll nearly always find room for improvement. We'll go over many value-creating techniques in later chapters, but for now, realize that many (if not most) affordable income properties offer potential for turnaround and higher net incomes.

Economies of Scale As with acquisition and strategy, income properties offer economies of scale when it comes to making improvements. To reposition, say, 12 houses, you work with 12 different buildings in 12 different locations. Each property requires its own unique market research, design, repairs, and renovations. In contrast, you can improve one 12-unit property with less time and effort (per rental unit).

Your renovation costs also incorporate economies of scale. One large roof costs much less than 12 individual roofs. To the extent that each of a building's individual units are similar, you can apply one redesign to all units. When you focus on one, two, or even three larger properties instead of a dozen or more smaller properties, you achieve more return for each hour you invest.

Summing Up

As we look in to the years ahead, real estate investors who in previous years would have searched only for single-family houses will switch to income properties. Such investments provide economies of scale; they cost less per unit; they yield higher annual cash flows; and they present greater opportunities to create value, to reposition, and to turnaround through improved operational and strategic management. When compared to stocks, bonds, annuities, or other assets, owners of income properties will produce superior performance. In fact, just as I was completing this book, a feature article in the *Wall Street Journal* ("Investors Considering Retirement Opt for [Commercial] Property Investments," December 18, 2007) essentially promotes the same message that I advocate here. The article quotes a Mr. Larson who says, "With the stock market, you're investing in faith. But with commercial real estate you can quantify everything and even drive by it on Saturday to make sure that it's still there."

Affordable income properties yield superior performance.

The journal goes on to report that "more investors are following Mr. Larson's example. As they're looking to build nest eggs that may need to last 30 to 40 years or more, commercial real estate seems like a stable investment compared to stocks—and it delivers a larger regular income stream. . . . Indeed while the residential markets in some areas continues to struggle, commercial real estate shows solid fundamentals."

But as the article also points out, beginning commercial-multifamily investors must study the local economies where they plan to invest, learn to run the numbers, and figure out target markets. Fortunately, that's the knowledge that you will take away from this book. Although, as noted, I focus primarily on the multifamily side of the commercial real estate market, the world of affordable commercial properties offers a magnificent

variety of other choices. I urge you to consider starting here and then move on to other opportunities as you gain experience. But if you do wish to jump right in to retail, offices, self-storage, or other types of commercial properties, you just follow the same fundamental analyses.

I wish you good luck and prosperity with your investing.

CHAPTER 2

Craft Your Market Strategy

Ever since William Nickerson wrote his now classic *How I Turned $1,000 into a Million in Real Estate—in my Spare Time* (Simon & Schuster, 1959), best-selling real estate authors have been revealing the secrets of my success. But here's the catch: With commercial income properties, if you merely adopt an investment approach that someone else developed in another place and time, you may lose your bank account or even more likely, you miss the best emerging opportunities. Why? Because investment property markets experience continuous change.

Think about interest rates; vacancy rates; property prices; rent levels; employment; population demographics—consumer tastes, working habits, shopping habits, preferences, attitudes, and lifestyles; the cost and quantity of new construction; and government zoning rules, regulations, and restrictions. These variables and dozens of others not only shift across time but also across countries, states, cities, metropolitan areas, types of properties, and types of tenants.

An investor asked me if HUD's Section Eight rental program was worth pursuing. I answered, "It all depends." In Orange County, Florida, I'm told that most rental property owners refuse to deal with it. In nearby Seminole County, some investors say they love it. Section Eight tenants stay put and pay on time.

No one can tell you the five easy steps to real estate riches.

It All Depends

No doubt, gurus can suggest ways to juice up your profits. But, please, do not mindlessly follow the experience of others. Instead, adapt, experiment, discard, and create, according to your own investment opportunities and goals.

A Strategy of Your Own

So, in this book, you won't find "five magic paths" or "seven easy steps" to real estate riches. You won't receive a list of detailed do's and don'ts. You will not memorize phone scripts. And I won't pretend that you can profitably buy, improve, and manage income properties without effort, time, intelligence, and at least a workable amount of seed capital.[1]

However, I do promise to share the knowledge and techniques necessary for you to develop a profitable, wealth-building strategy of your own. You conquer the challenges and opportunities of income property investing only when you know how to discover current market facts and adapt as problems arise and solutions unfold. In other words, from this book—as with no other—you learn to think strategically.

PVP: The One Constant Rule

To think strategically, adopt one rule: the preferred value proposition (PVP). All types of tenants (retail, office, residential) compare features, amenities, location, rent levels, lease terms, and dozens of other details that add to (or detract from) what they demand from a property. They compare, contrast, weigh, and

[1]This money does not necessarily have to come from your pocket. Partners or relatives frequently provide seed capital and credit for both beginning and experienced real estate investors.

Offer your target market superior value.

consider. In the end, which property do they choose? The cheapest? Not necessarily. The best? Probably not. The biggest? Maybe, but don't count on it.

Tenants choose the property that offers the value proposition that they prefer relative to other properties they consider.

"Okay," you might say, "what's new here? You state the obvious." To that I respond both "Yes" and "No." Yes, because in one sense, everyone knows that (absent coercion) people choose their best deal. But when it comes to the practices of property owners, managers, and renovators, I answer an emphatic "No!"

During the past 20 years, I have reviewed more than 1,000 commercial investment property offerings (for lease, for rent, or for sale). At least 90 percent of these properties would have benefited from better marketing.

And by "better marketing" I don't mean better advertising or better salesmanship (although these, too, showed shortcomings). I mean the strategic effort. The owner, manager, or property agent had not adequately addressed the PVP question that profit-seeking investors must answer. Namely, "How might we enhance our value proposition in ways that would better satisfy (amaze, woo, wow) our customers (tenants, buyers) and at the same time drive more dollars to our bottom line?"

To improve, strive to improve. Make the effort. Believe that effort will pay off. Cultivate an entrepreneurial attitude. Create a PVP for your tenants-to-be.

The DUST Strategic Framework: Questions to Answer

Look at Figure 2.1.[2] You can quickly grasp the strategic reasoning that guides you to succeed:

[2]The acronym DUST refers to the four key areas that smart investors investigate: (1) *D*emand, (2) *U*tility, (3) *S*upply, and (4) *T*ransfer process.

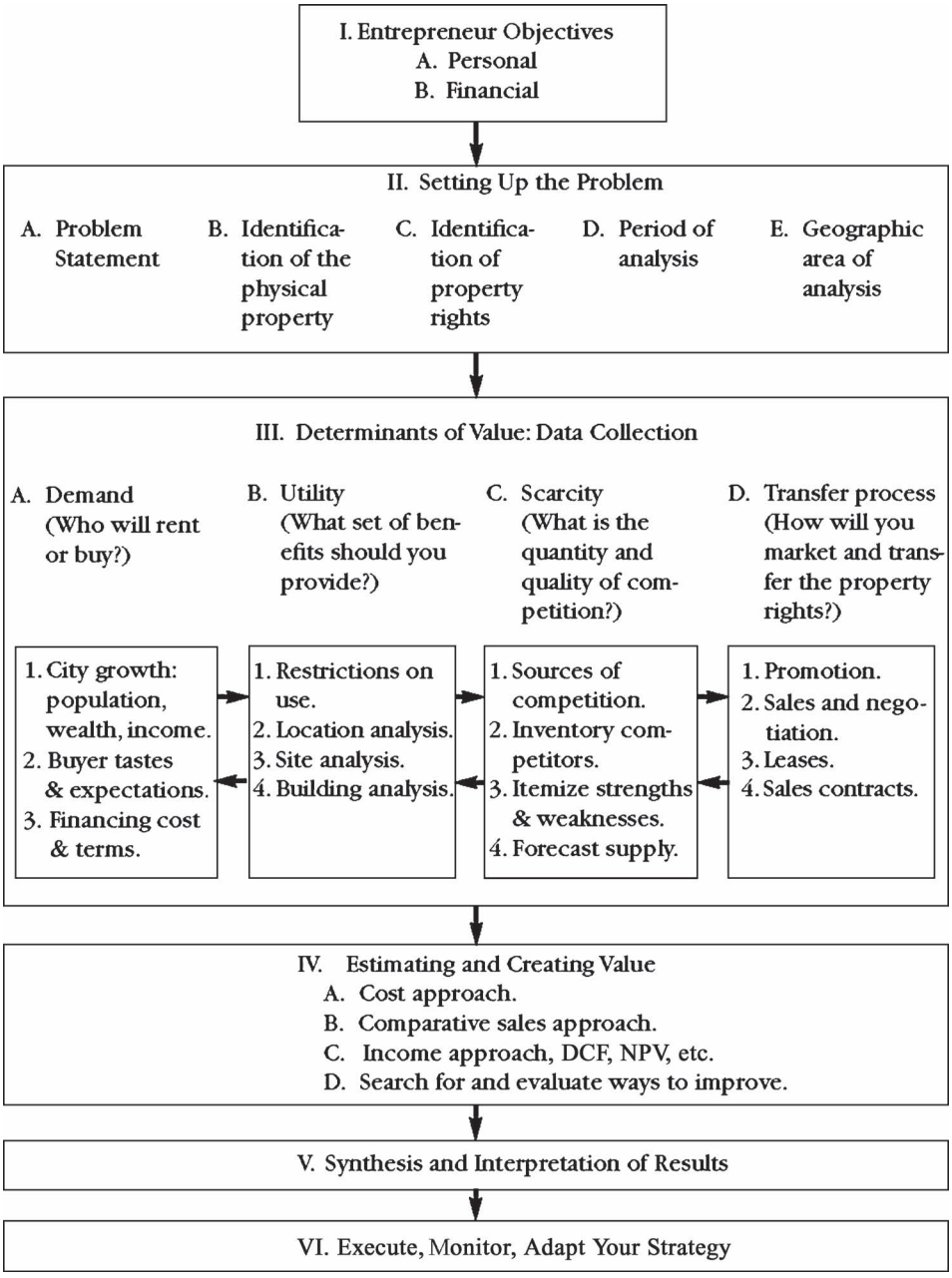

Figure 2.1 DUST Strategic Framework.

1. Know thyself.
2. Frame your due diligence.
3. Systematically collect, interpret, and reason through market data.
4. Formulate market strategy(ies).
5. Execute, monitor, and revise your value proposition.

Entrepreneur Objectives: Know Thyself

Nearly everyone wants to make money. But before you run with the herd toward the next big thing, measure your personal and financial resources, your talents, and your objectives. Then choose an investment program and market strategy that best serves your purposes and desired style of life.

Talents, Inclinations, and Resources

When I began to buy and renovate investment properties, I not only lacked a clear plan but I failed to inventory my talents and inclinations. Only through trial and error did I manage to stick with real estate and eventually developed an investment program that worked for me both personally and financially. Many would-be real estate investors choose the wrong program, or the wrong way to execute, and then give up before they've given the field a fair chance.

Before you jump into a so-called good deal, review how well your investing will align with your personal abilities, resources, likes, and dislikes. Answer these questions:

1. *Time and money.* How many hours per week or per month are you willing to invest? Realistically, what does your financial profile look like (credit, cash, earnings, borrowing power)?

2. *Trade skills.* What types of handyman talents do you possess? Do you enjoy this type of work? Are you willing to learn how to work with contractors and manage construction rehab and renovation projects?
3. *Creativity and design.* Do you enjoy searching out new ideas? Are you willing to learn and adapt the ideas of others? Would you like looking at properties, attending trade shows, and browsing through magazines and journals to learn more about property management, creative improvements, and related topics?
4. *Partners.* Do you prefer to play as a one-man band, or would you like to join with others to share financing, work, responsibilities, and decision making?
5. *Tenants.* What types of tenants would you like to work with?
6. *Real estate agents.* Do you want to search and sell on your own, or will you employ real estate agents?
7. *Numbers.* Can you learn to work with income statements, cash flows, rate of return calculations, cost estimates, budgets, and tight rehab and renovation schedules?
8. *Personal achievement.* What types of real estate would give you the greatest sense of personal achievement and pride of accomplishment and ownership?

No matter how you answer each of the above questions, you can develop a strategy that more or less fits your desired profile. The key is to anticipate and prepare, to harbor and hold expectations that match reality. Many investors try to do it all. They burn out long before they realize their potential. Others buy with little or nothing down and then find they lack cash or credit to navigate through stormy weather. Fortunately, such mismatches of time, talent, and money often produce distressed owners who sell at bargain prices—just to get rid of their difficulties.

Their loss becomes your gain.

Assess Your Finances

The nothing-down real estate promoters have pulled too many starry-eyed investor wannabes farther down the path to financial ruin with their mantra of "no cash, no credit, no problem." Although you can buy real estate without cash or credit, that fact begs the question, "If that is your situation, *why* do you lack cash or credit?"

To succeed in real estate (as with all other types of investing), exercise financial discipline and responsibility. "No cash, no credit" certainly poses a problem when an impecunious position results from excessive spending and borrowing.

Never believe that investing in real estate will put you on the road to financial freedom absent a diligent capacity to save, borrow, and spend wisely.[3]

Financial Position Manage your finances as a borderline miser. Assess your credit capacity, available cash, and regular monthly cash flow. How much can you allocate to real estate acquisitions and fix-up work and still maintain a reserve to cover contingencies and emergencies? Because you will commit beginners' mistakes, don't push your limits. Use your first properties to gain experience and fine-tune your strategy. To see where you now stand, answer the following questions.

What Are Your Credit Scores? In their efforts to determine whether you're a good credit risk, most mortgage lenders will run your credit scores. Although many credit-scoring systems now exist, the most widely used scores are calculated by Fair Isaac Company (FICO) algorithms. To learn your FICO scores, go to www.myfico.com. For $39.95, Fair Isaac will calculate your three scores

[3]For a good book that describes financial habits that build wealth, see Dr. Thomas J. Stanley, *The Millionaire Next Door—The Surprising Secrets of America's Wealthy* (Longstreet Press, 1997).

Check your credit score.

(based on credit data from Experian, Equifax, and TransUnion) and suggest ways to improve them. Fair Isaac provides some ideas about the interest rate that lenders would charge you. (However, as we discuss later, loan underwriting and loan pricing depend on many factors other than your credit scores.)

What Is Your Net Worth? Net worth consists of the value of what you own less the amount you owe. (If you've previously completed a mortgage application, you're familiar with this form, which is called a *personal balance sheet.*)

How Liquid Are You? Mortgage lenders do not just focus on net worth; they evaluate your cash position. Generally, the more cash you have on hand, the better you can get through adverse times and unanticipated setbacks. Of course, you (or your partners) will also need some cash to close (down payment, closing costs, mandated property repairs, and perhaps, property improvements). If your balance sheet shows low amounts of cash (or near cash such as stocks, bonds, or CDs), consider selling some assets (cars, boats, vacation home, jewelry, and so on) to beef up your cash account. Liquidity not only adds to your credit capacity but also gives you the ready money to quickly jump on good deals when they arise.

How Much Residual Income Do You Generate Each Month? Do you save regularly or live paycheck to paycheck? Month-to-month survival impedes your ability to build wealth and borrow productively.

To boost your savings, write out what spending you can slash, what debts you can eliminate, and what luxuries (frivolities) you can do without. Then act. To invest enough money to build wealth while you're still young enough to enjoy it, discipline your

How much money do you want to make?

spending and (destructive) borrowing. Live well *below* your means.

Financial Goals Given your financial resources and personal capabilities, how much money would you like to make over the next 5, 10, or 20 years? How many properties (and at what price points) would you like to acquire? Do you plan to fix and flip, fix and hold, or buy and hold? Do you lean toward retail, offices, or residential? Play around with some numbers. What looks doable? After you've worked through the numbers, commit a plan to writing. Attach a timetable. Set deadlines. Without a written plan, timetable, and goals, most people procrastinate. They drift. They regret. Avoid this trap. Commit yourself on paper and with action.

At this point we haven't discussed all types of commercial and investment opportunities that are possible for entrepreneurial investors. But after you read later chapters, return to this exercise. Work through possibilities. With goals in mind, map a path that leads you to them.

Frame Your Due Diligence

To achieve superior profits and minimize risk, set up your due diligence to frame your opportunities and risks.

- Identify the physical property.
- Identify the property rights that will come with ownership.
- Identify the area(s) that delineate the reasonable geographic boundaries for supply and demand (the areas for each may differ).
- Identify your time period concern.

Identify and Fully Describe the Physical Property

To evaluate and compare investment properties, identify and describe each physical property in the following ways:

- Number and mix of the rental units
- Square footages of the total building and each rental unit
- Site size, boundaries, and amenities
- Type of construction, architectural style, quality, and condition
- Personal property and/or trade fixtures

Investment properties come in a wide variety of sizes, shapes, styles, and conditions. Property price ranges, monthly rents, and vacancy rates vary widely. This preliminary information helps you in two ways: It narrows your search to those properties that fall within your desired categories of investment, and it assures you that you know exactly what you're buying—and what you may be passing up (opportunity costs).

Not all income properties offer the same potential.

Number and Mix of Rental Units Due to overall conditions of market supply and demand, various types of buildings and rental units experience different degrees of rental appeal. In some markets, a four-unit building that consists of all two-bedroom, one-bath units (2/1s) may rent much better than a four-unit building that includes all one-bedroom, one-bath units (1/1s). Or say you face this choice: You can buy a 12-unit apartment building that includes four efficiencies, four 2/1s, and four 1/1s, or you could buy a 16-unit property that consists of all 2/1s. Which is best? Or you might find a hands-off investment: say, a post office building net leased to the U.S. government for the next 10 years. Should you buy it?

No one answer exists. It depends on the nature of the local market. That's why your market analysis should identify the types

Never rely on a so-called market vacancy rate.

of buildings that best meet your personal and financial goals. I've seen beginning investors jump to buy, say, a 12-unit, supposedly bargain-priced building of 1/1s only to learn that the market was oversupplied with 1/1s. These investors then suffered more turnovers and higher vacancies than anticipated.

You will see figures on vacancy rates for the office "market," retail "market," and apartment "market." Never accept those figures at face value. On closer inspection, you will find that vacancy rates and tenant turnover do not hold constant across types of properties, neighborhoods, price ranges, and unit mixes. Talk with real estate agents, property managers, and other investors. Follow listings of rentals. Learn about the widely diverse rental submarkets that combine to produce that market average.

Square Footages When you look at multi-unit properties, agents and owners typically quote you two types of square footage figures. One figure applies to the total size of the building. The other type applies to the sizes of the individual units. The naïve investor accepts these square footage figures at face value. The smart investor questions the figures more closely.

What floor areas are counted within the square footage figures? Buildings may devote space to hallways, basements, balconies, laundry facilities, and HVAC equipment as well as the actual rental areas themselves. Always break down total square footage figures and allocate them across the various types of building uses. A careful investigation requires this step for two important reasons.

First, no single standard applies to square footage measurements. Some owners or agents may count basements and balconies. Others may not. Again, precision helps you compare apples to apples. Second, you want to especially take note of *rentable* square footage. Some buildings waste a lot of square footage

due to inefficient design. A building of 13,500 square feet might actually include more rentable square feet than another property that measures 15,000 square feet.

Furthermore, not all rentable space counts as usable space—especially in office and retail properties. Tenants, of course, prefer a high percentage of usable space (the efficiency ratio).

Not all square footage counts equally.

Owners and agents sometimes like to push their properties as a great buy because they compare favorably to the asking and/or sales prices of other properties on a price-per-square-foot basis. If the quality of that property's square footage is inferior to its peer properties, however, it deserves to sell at a discounted price per square foot. The lower asking price does not signal the great buy that the seller is claiming.

Are the Square Footage Figures Accurate? Even though sellers and their agents nearly always disclaim their estimates of square footage, beginning investors still too often rely on the seller's figures only to learn later that those figures erred. In those instances where price per square foot counts heavily in your property comparisons and evaluations, pull out your tape measure. Check the relevant dimensions for yourself. That's the only way that you can protect yourself against the future shock of adverse surprise.

Are the Rental Units the Right Size? I've seen 2/1s as small as 600 or 700 square feet and as large as 1,300 or 1,400 square feet (not counting, of course, those premium-priced extravagant units found in luxury buildings in major cities and resort areas). Efficiencies may range in size from as small as 125 square feet up to 400 or 500 square feet. Other combinations of rooms and unit types also vary in size.

To invest profitably, get a feel for the unit sizes that command the most appeal in your market. When a rental unit with the right combination of rooms still seems too small (or even too large), you will run into trouble keeping it rented without discounting the

(p.s.f) rent level. Even with a rent discount, wrong-sized units will typically suffer greater tenant turnover.

Site Size and Features In many cities, the value of the land on which a building sits can easily total 30 to 70 percent of the property's total value. Even small differences in site size or features can add (or detract) tens of thousands of dollars vis-à-vis other seemingly similar properties.

I recently looked at two triplexes. Both properties brought in about the same amount of net income, yet one property was priced at $189,000 and the other was priced at $209,000. If I only considered the buildings themselves, the $189,000 property clearly looked like the better buy. But, in fact, the $209,000 property offered hidden value in the site. It turned out that this property's site size (and zoning) would permit a fourth unit to be built.

Closely evaluate the size and quality of the site.

Additional site size might prove valuable for adding on to a building, creating more parking or storage space, or providing better privacy. To evaluate a site, take note of the quality of its landscaping and its egress and ingress (how easily cars can pull in and out of the property). Although uncommon in small income properties, on occasion you might find that a property includes a swimming pool, tennis courts, or other potentially desirable features and amenities.

When you compare commercial investment properties, recognize that site size and features significantly affect the value of the total property. Make sure you itemize all variations that make a difference.

Type of Building As you begin looking at properties, you will find all types of architectural styles, construction materials, and designs. These properties may also range in condition from pristine to borderline teardown. Some are high maintenance; others are low maintenance.

My first experiences. When I began to buy apartments, I bought old, large, single-family houses that had been converted into multi-unit properties. These apartment buildings are priced at the low end of the market; they produce great cash flows; and because they may be difficult to finance through banks, owners often offer seller financing.

Converted large houses can make great starter properties.

On the downside, buildings of this type suffer functional and physical obsolescence. They're typically high maintenance, and they often lack unit-controlled heating and air-conditioning units. Even so, for entry-level investors with limited cash or credit, this type of property makes a great starter investment.

Your Experience Depending on your resources and inclinations, such older properties may or may not appeal to you. But I would encourage you to get out into your market; look at properties; and compare prices, rent levels, cash flows, and managerial and/or maintenance requirements. Then decide on the type of property that fits your investment profile. Just as Baskin-Robbins offers multiple flavors of ice cream, the real estate market offers multiple types of properties. Each type appeals to different types of investors. Before you decide, inventory the choices. Evaluate the pros and cons of the properties and their tenants. (Of course, as an entrepreneur, you may wish to buy a property that exhibits a given use and tenant type, and then reposition toward another use and tenant mix.)

Personal Property When you buy real estate, you purchase the land and the buildings, that is, real property; however, part of a seller's asking price might include personal property, such as laundry room equipment, window coverings, refrigerators, stoves, and, on occasion, furniture.

Also, the price of the property could include items that are personal property by nature but have been adapted for use with the building. The law classifies these items as *fixtures.* Fixtures

typically include property such as ceiling fans, window air-conditioning units, chandeliers, garage door openers, garbage disposals, built-in cabinets and bookshelves, and dishwashers. In office and retail properties, tenants install trade fixtures useful to their businesses, which, in most cases, remain the property of the tenants and do not convey with the real estate.

Property Evaluation For purposes of property analysis and evaluation, understand not only the characteristics of the real property but also the precise description and listing of all personal property and fixtures the seller will transfer to you at closing. Other things equal, an apartment building where each unit is furnished with a washer, dryer, ceiling fans, range, dishwasher, and refrigerator is worth more than one that doesn't include such amenities.

Never pay much for furniture and appliances.

Source of Mistakes Even though a property that includes personal property and fixtures is worth more than a similar property that lacks these items, the question becomes, "How much more?" The answer is, "Not as much as you might think." We specifically address this issue with numbers when we get to Chapter 6 on financial analysis. For now, keep in mind that commercial investment properties differ with respect to personal property and fixtures. These issues add another variable to your investment analyses.

Understand Your Bundle of Rights and Restrictions

"This is *my* property! I'll do with it whatever I want." In long-ago times that predate zoning; building codes; tenants' rights; mortgages; written leases; and other laws, ordinances, and contracts, such an uncompromised claim to ownership may have carried weight. But not today.

Today, your rights to use, design, occupy, lease, mortgage, construct, add on, or enjoy a property will be restricted in a dozen

Before you buy, verify what legal restrictions apply.

or more ways. As a smart investor, verify that your strategic plans for the properties you buy, manage, renovate, lease out, and sell comply with the legal rights that you possess. Your legal rights will be limited by some or all of the following types of restrictions.

Zoning In most cities, any property you buy will be located within a zoning district that is identified as, say, R-1A, R-4, C-2, or one of more than several dozen types of districts. You can learn the applicable zoning district for any property by consulting your city or county's zoning map. After you learn the district classification for the property, consult the corresponding rules and regulations of the written zoning ordinances. These rules apply to the following:

Use restrictions. Rules of use deal with questions of residential, commercial, retail, mobile home, professional, office, industrial, or increasingly, various mixed uses (such as buildings and developments that include offices). These laws typically subdivide each of these major categories even more precisely. One residential zoning district might permit duplexes, where another will permit up to 24 units, and another might exclude all residential uses except single-family houses. Some zoning districts are called *exclusive,* while others remain *inclusive.* An inclusive commercial district might permit multi-unit residential, whereas an exclusive district prohibits all uses except those that the law specifically lists.

Height and setbacks. Height restrictions limit the height of buildings (including roof signs and chimneys), and setback requirements tell property owners how closely they may legally build toward the front, side, and rear boundaries of a site. In addition to the building itself, setback distances may also apply to garages, decks, patios, paved parking areas, driveways, tennis courts, and swimming pools.

Height and setback requirements not only govern new construction but also limit what you can do to your property through

renovations, conversions, and building additions. Before you buy a property with plans for improvement or additions (up or out), verify the legality of those changes. (Of course, this principle applies to all types of restrictions, not just height and setback rules.)

Occupancy. The zoning code's occupancy rules may limit the total number of persons who may live (work, shop, dine, etc.) in a space. In my city, investors sometimes rent out their units to groups of four or five college students; however, single-family zoning districts limit occupancy to three unrelated adults. Some cities limit occupancy to two persons per bedroom. In Dubai, some neighborhoods prohibit bachelors.

When your market strategy aims for high-density occupancy, your plans may run counter to the law. Governments typically avoid enforcing occupancy laws unless they receive justifiable neighborhood complaints. Nevertheless, if you buy a property that crowds tenants into the units (and thus greatly increases the cash flows from the amount of rent that otherwise could be obtained), check the legality of this strategy. If illegal, factor that risk into your purchase offer. If or when government seeks to enforce the code, you could see your gross rent collections plummet.

Architectural review boards. Some communities may even regulate the color you paint a property or whether you can put up or take down shutters. Properties that are located in historical districts are especially susceptible to various architectural or historical purity regulations.

During a one-year period in San Francisco, the dictatorial architectural review board (ARB) received 12 renderings from developers who wanted to construct new high-rise projects in the city. The ARB rejected all of them on "aesthetic" grounds. For existing investors, rigorous limits on new construction and renovations do reduce the number of competing properties.

Lot size and building size. Assume that you find a great vacant lot in an area zoned for quads. The financials look good for new

Coordinate a legal strategy with your market strategy.

construction, and you're about to close the deal when you discover a glitch. The size of the lot is too small—not too small to physically build the unit but too small for purposes of the zoning code.

Or say your study of the housing market shows a strong demand for efficiency apartments of about 350 square feet that would easily rent at the profitable rental rate of $650 per month.

Alas, you find that zoning won't permit you to carry out this market strategy. The law may require that all residential rental units must contain a minimum of 500 square feet. Of course, if you built (or remodeled) to this larger size, your costs would increase and you would have to charge a higher rent. This low-end market segment of tenants who would prefer to live alone is essentially forced into rental share arrangements because the code excludes small, less expensive rental units.

When building, managing, and renovating investment properties, find the most profitable market strategy within the requirements of the law. If you do not comply with every detail of the law, government regulators can force you to shelve your grand plans—even when you've got tenants ready and willing to pay for what you would like to offer.

Building Codes Building and construction codes attempt to enhance the safety of buildings. To guarantee compliance, cities and counties usually require major repairs, remodeling, and renovations (as well as new construction) to pass through a government permitting process. Some property owners sidestep the permitting process, usually to save time, trouble, and money. These owners hire unlicensed contractors to complete their unpermitted improvement projects.

Beware of bootlegged work.

Two implications. As a potential investor and property owner, the possibility of bootlegged work holds two implications: Never buy a

property that has been subject to unpermitted work unless you receive a steeply discounted price. When you improve your own properties, secure necessary permits and inspections. Should you buy, own, or try to sell a property with nonconforming improvements, at some point when the inspectors do eventually discover the violations, they can force you to rip out the work and do it over in a manner that complies with the law.

Times have changed. Years ago, the permit process and follow-up inspections were lax in many communities. Bootlegged work presented little risk of discovery. Today, and looking into the future, few officials will turn a blind eye to code violations and unpermitted work. In addition, should nonconforming, unpermitted work cause or contribute to the injury or death of a tenant (guest, customer, worker), you could face serious liability problems. Unless you like to tempt fate, verify that every property you buy or own complies with all building codes and other applicable rules and regulations.

Environmental Laws Investment properties are most affected by environmental laws that relate to lead paint, asbestos, radon gas, and buried heating oil tanks. In addition, be wary of waste disposal (sewage) systems that aren't connected to a municipal sewer line. You may think that in this modern era, no urban properties would lack sewer connections. Unfortunately, that's not the case. For example, Sarasota County, Florida, is one of the wealthiest urban areas in the United States, yet tens of thousands of properties in that county (even some on major thoroughfares) remain without a modern sewer system.

For a complete rundown of the environmental issues that may apply in the areas where you plan to invest, consult your state or local environmental protection agencies for their informative brochures. Also, the U.S. Department of Housing and Urban Development (www.hud.gov) publishes a variety of brochures that discuss environmental issues of interest to owners of residential properties.

Lease Terms When you buy a property that is currently occupied by tenants, you must continue to honor the terms of those leases. Do you plan to increase rents? Do you plan to make renovations? Do you plan to move into that choice corner unit with gorgeous views of both the bay and the mountains?

Read the tenants' leases before you buy.

If your tenants' existing leases give them rights that conflict with your plans, you must put your plans on hold until those leases expire.[4] That's why you must secure and read copies of every lease that applies to the units in the buildings that you are buying. Who knows? Unless you read the leases, you may learn too late that the seller has given his brother a written five-year lease on the best unit in the building at a rent level that's half the market rate.

Moreover, retail and office leases (with renewal options) often extend for 5, 10, or 20 years. Leases often seriously curtail your rights to retenant and/or reposition a commercial property.

Tenants' Rights Laws Check with regulators or an attorney to learn whether your tenants-to-be are covered by any type of tenants' rights laws. Such laws might pertain to rent increases, mandated repairs, condominium conversions, evictions, or security deposits. Generally, when a lease conflicts with a tenants' rights statute (or a court decision), the law stands supreme.

Before you buy, rent the video *Pacific Heights*.

The spread of consumerism. With society's shift to so-called consumer protection laws, state and local governments set more and more rules to govern investor-tenant relations. Follow the technicalities of these laws in detail; otherwise, you open yourself up to costly penalties.

[4]As an alternative, you could try to negotiate with the tenants to modify the terms of the lease. Some investors even pay the existing tenants to vacate earlier than the lease stipulates.

Tenants' rights can hurt those who are their intended beneficiaries. For a horror story of residential tenant rights, watch the video movie *Pacific Heights* starring Michael Keaton as the evil tenant who knows how to play the San Francisco housing court system for all it's worth. On the bright side, had the owners of the Pacific Heights property featured in the movie continued to own that building through 2008, they would have seen it more than quadruple in value during the 15 years since the movie *Pacific Heights* was filmed.

Left-wing politics creates real estate millionaires.

In a narrow sense, lopsided tenants' rights laws seem to favor tenants. Over the longer run, such laws discourage new housing supply and thus drive down vacancies, push up property prices, and make life miserable for all persons who would like reasonable accommodations at an affordable price, either through rental or purchase. High rent levels and property prices now prohibit nearly all of the middle class from living in San Francisco. Property investors, though, have made millions.

Fair Housing Laws Federal, state, and local laws outlaw certain types of discrimination. If you own a 12-unit apartment building, neither you nor your manager could refuse to rent to tenants because of their sex, race, religion, color, ethnicity, disability, or children (unless you own a property that fits within the age-55-or-over exception).

However, some states and cities (and courts) have expanded the categories of protected tenants to include, for example, homosexuals, cohabiting couples of the opposite sex, college students, and members of the military. To learn the fair housing laws that apply to your properties, consult an attorney or your local fair housing office.

Also, fair housing laws frequently exempt certain types of properties such as single-family houses, roommate shares, and two- to four-unit owner-occupied buildings. When it comes to compliance with fair housing laws, tread carefully. Violations (and

especially a longstanding pattern of illegal practices) could easily cost you your life savings. Take no chances here. Learn the law. Follow it scrupulously.

Mortgages Relatively few people know that mortgage contracts limit you in several ways.

Buy a quad. Live in one unit.

Owner occupancy. Mortgage lenders give their most favorable loan terms and lowest interest rates to borrowers who live in the property that they are financing. That's why I encourage first-time (or cash-short) investors to buy a two- to four-unit property. Agree to live in one of the units for at least a year, and you can finance the deal with a down payment of just 3 to 5 percent.

Even so, never lie about your intent to occupy a rental property so that you can qualify for easier and lower-cost financing. Some investors pull this trick, but they don't realize that this deceit exposes them to foreclosure and a felony conviction with heavy fines and an extended stay in federal prison. When you tell a lender that you will live in a property, you are legally and contractually bound to abide by that commitment (unless you experience a truly unexpected and serious change of circumstances).

Property alterations. Many mortgages include a clause that reads something similar to the following:

> Borrower shall maintain the property in good repair and shall make no material alterations without the written consent of the lender.

This requirement can affect you in two ways. It limits your right to become a slumlord. If you bleed a property to the extent that it becomes run down, the lender could declare the mortgage immediately due and payable. If you fail to pay off the loan as demanded, the lender could foreclose.

Consult your lender before you renovate.

Also, this clause requires you to notify the lender and seek permission before you undertake extensive renovations, remodeling, additional construction, or even change of use (i.e., from residential to office, or say from single-family to multi-family).

You might wonder, "Why should the lender care? Surely, if I improve the property, the lender's position becomes more secure because I'm increasing the value of the property." Unfortunately, on occasion, your supposition proves false.

Not all owner-designed improvements create value. Time and time again, I've looked at a remodeled property and have just been amazed. As I stare at some bastardized renovation, I ask myself or the real estate agent, "What in the world was this guy thinking?" Many owners fail to test their personal tastes and creative ideas against the opinion of the marketplace. (Of course, you won't make this mistake because you will thoroughly research tenant preferences before you begin your improvements.)

Easements Through an easement, one party obtains the right to use the property of someone else for a specified purpose. For example, owners of beachfront properties may have to grant the public an access route through their land. Utility companies often secure easements to erect and maintain electrical lines or water pipes. In cases where one building lot is split off from another street-fronting lot (removing street access), the owners of the back lot may gain a driveway easement through the front lot to access their property from the street.

Easements may add or subtract from property value.

As an investor, clearly identify any easements that may restrict your right to use or improve any properties you plan to buy. On other occasions, as the purchaser of a property, you may obtain easement rights to use or pass through the property of someone else. Either way, easements (or the lack thereof) can

materially affect the value and usability of a property. Make sure you fully understand the precise nature of any easements that apply to your real estate investments.

Homeowner Associations and Deed Restrictions In addition to all of the rules and regulations of government, many property owners must also comply with a myriad of property owner association restrictions. Such rules are typically drafted by the elected officers of the association. In addition, some rules of usage also "run with the land." This phrase means that the rules are actually recorded in the deed to the property that is located in the county (parish) courthouse.

Although property owner association rules and deed restrictions most commonly apply to condominiums, townhouses, and single-family houses, such restrictions may also apply to investment properties. I am currently negotiating the purchase of a triplex on Siesta Key (Florida) that is actually part of a condominium association of just four properties (all triplexes). Some of the pertinent restrictions for this property are shown in Figure 2.2.

Property Rights: Summing Up We began this discussion of property rights with the once often-heard boast, "It's my property. I'll do with it as I please." As a smart investor, you now see that that boast sounds foolhardy.

To avoid unpleasant surprises, take nothing for granted. Before you buy, investigate everything from A to Z—from association rules to zoning. Many property owners have created great strategic plans for their sites and buildings only to later learn that such plans violate some law, rule, regulation, or contract restriction. It's true that you *will* profit most when you tailor your physical property and managerial operations toward a well-chosen market segment of tenants, but it's also true that to earn those profits, you cannot charge ahead with your eyes closed.

This caution especially applies at the time you negotiate price. Without knowledge of restrictions, you may overestimate

Those rules that are specifically set forth in the Declaration, By-Laws, or Articles of Incorporation as amended or that have been adopted by the Board of Directors will be strictly enforced. Your reading of these rules and your voluntary compliance with them will facilitate the proper management of this condominium and promote the best interests of all unit owners.

I. *ANIMALS OR PETS*

1. Only one (1) cat, bird, or small dog (under 15 pound) may be kept in a unit. The occupant will be responsible to repair all damage done by a pet and will indemnify and hold the Association and the Board of Directors harmless against all claims for injuries to persons or damage to property caused by their pet.
2. Pets are the responsibility of their owners and shall not become a nuisance or disturbance of any kind to others. Alpino Bioanco Villas has always had a leash rule. Pets are not permitted on Condominium property unless accompanied by their owner. Pets may NOT be tied outside the unit and left unattended, nor will they be permitted to roam. OWNERS MUST CLEAN UP AFTER THEIR PETS. OTHERWISE, OWNERS WILL BE FINED AND IF VIOLATIONS CONTINUE, THE PET WILL BE DECLARED A NUISANCE AND REMOVED FROM THE COMPLEX.
3. All pets must be registered with the Association office.

II. *VEHICLES AND PARKING*

Each unit shall be assigned one (1) regular parking space for a passenger automobile. The remaining four (4) parking spaces are reserved for guests and business and visitors. All vehicles to be regularly parked must be registered with the Manager. No trucks, commercial vans, pickups, lettered vehicles, motor homes, or travel trailers may be parked on the Condominium property except temporarily while servicing a unit, loading or unloading. Any longer period than overnight is prohibited. No boats or boat trailer may be parked on Condominium property at any time.

Abandoned vehicles will be towed away at the owner's expense. All parking spaces shall be kept clear of refuse, parts, equipment or other materials.

Bicycles, mopeds, motorcycles, and similar vehicles may be stored in designated storage areas under the buildings at the risk of the owner.

Figure 2.2 Sample Triplex Condominium Rules and Regulations.

III. *USE OF OUTSIDE PORCHES AND STAIRWAYS*
Second-floor occupants may not use the porches or railings for airing bedding, drying clothing, or other materials. Barbecue grills or equipment may be used only on ground-floor grass or concrete areas, not on balconies due to fire hazard. All loose and moveable objects should be removed during severe windstorms.

IV. *GARBAGE AND TRASH*
All garbage, trash, and refuse must be placed in plastic bags, taped or tied at the top, and placed in garbage receptacles. No junk, inflammable materials, or discarded materials may be allowed to accumulate, and each unit and the common areas shall at all times be kept in a clean and sanitary condition. Occupants shall not allow anything to fall or be thrown from second-floor windows, doors, or balconies.

V. *STORAGE ROOMS*
Storage rooms may be used for storage of household goods, hobby materials, and equipment, but all risk of loss or damage shall be assumed by the owner of such materials. No activity shall be conducted in the storage rooms that would constitute a fire or health hazard, increase insurance rates, or create a nuisance to the other occupants of the Condominium property.

VI. *NOISE*
Radios, recording amplifiers, and television sets must be turned to a minimum volume between the hours of 11:00 P.M. and 8:00 A.M.

VII. *OCCUPANCY*
No unit may be occupied on a regular basis by more than two persons per bedroom. This rule shall not apply to occasional visits by houseguests. No occupant shall make use of any unit that violates any laws, ordinances, or regulations of any governmental body, the Condominium documents, or these House Rules.

VIII. *MISCELLANEOUS*
Under no circumstances may a unit be occupied by a minor without supervision of a responsible adult.

Figure 2.2 *(Continued)*

the profit possibilities. Unwarranted optimism entices you into paying too much, or perhaps you borrow more than the property's realistic cash flows can cover. In today's investment climate, the highest returns are earned by those entrepreneurial investors who can turn an underperforming property into a winner. But your acts of magic can't succeed against adverse government rules (unless perhaps you fight for rule change or a variance).

Where Should You Invest?

For convenience, most investors who own single-family rental houses limit their search for properties to a geographic area that falls within a 30- to 60-minute radius of their personal residence. These investors want to remain close to their properties so that they can easily deal with day-to-day issues (showing the property, making repairs, disciplining tenants, and so on). As an owner of commercial investment properties, especially as you gain experience and trade up to larger properties, you can broaden your horizons. With investment properties, you delegate day-to-day tasks to your property manager and leasing agent.

Ideally, invest in those geographic areas that provide good cash flows and high potential for property appreciation. Before you choose a location, investigate its local job picture. Assess its potential for growth in population and new development of competing properties. During the next decade or two, real estate investors in some areas will enjoy a doubling, tripling, or even quadrupling of their property values and rent levels, whereas property owners in other locales may do well to merely keep up with inflation.

Discover where a local economy is headed. When possible, climb aboard a boat that's sailing into a rising tide. You can't expect your properties to show strong appreciation when they're sinking into the quicksand of economic decline. As I describe in Chapter 3, I learned this lesson early in my career.

Time Period

Think about the length of time you plan to hold each of your acquisitions. If you plan to fix and flip, your economic and market analysis need not look out further than 6 to 12 months. On the other hand, as a buy, improve, and hold investor, take a mid- to long-range perspective of, say, 3 to 15 years.

Different time perspectives lead to different investment choices. Right now, many lower-priced neighborhoods, communities, and even countries are poised for property appreciation; however, to be successful in some of these areas may require a patient investor. If you want to earn quick cash, find bargain-priced properties that you can fix up and immediately resell (or exchange). In any case, don't choose your locations or your properties until after you've clearly thought through the when and the how of your exit strategy.

Plan your exit strategy.

CHAPTER 3

Where's the Local Economy Headed?

Want to make money in real estate? Want to avoid losing money in real estate? Then monitor the population, employment, and income trends in the cities and neighborhoods where you invest. Or more proactively, look for those cities, neighborhoods, or countries that are poised for takeoff.

Nearly all real estate authors tell investors to buy at a bargain price. But what is a bargain price? Below-market value? Maybe. How about above-market value? Again, maybe. The fact is that you score a bargain anytime you pay a price today that will look dirt cheap 3, 5, or 10 years from now. How can you tell which markets will appreciate the most during the coming years? How can you tell whether that below-market price you pay today might look expensive (not cheap) 5 or 10 years from now? Study the economic base and growth potential of the area where you are investing.

During the early to mid-1990s, economic setbacks in Los Angeles, Houston, Dallas, Boston, and New York City pulled down property values. Real estate values fight a strong headwind if an area's job base deteriorates. In contrast, today's property boom in cities such as Charlotte and Dubai correlate strongly with the growing economic base of those areas.

To guard against capsizing your promising future, experience teaches four lessons:

1. Never pursue an investment strategy in real estate without closely monitoring the local economy and local real estate market where you are investing.
2. Beware of using more leverage (debt) than you can wisely handle; correspondingly, don't let those alluring high dollar returns spellbind you into growing too fast or taking on too many properties at the same time.
3. Plan multiple market strategies. Even boom economies can go bust within a period of 6 to 12 months—or perhaps we should say, *especially* boom economies can shift to bust relatively quickly.
4. Don't quit your day job prematurely.

Although we shall discuss each of these four lessons in due course, in this chapter, you learn how and why to judge the strength and direction of a local economy. Much (perhaps even most) of your profits (losses) will come from your choice of where (and when) to invest.

Economic Base Matters Greatly

"The author did it—and so can you!" So opens the blurb page of the classic bestseller *How I Turned $1,000 into a Million in Real Estate—in my Spare Time* by William Nickerson (Simon & Schuster, 1959). With these words of encouragement, I devoured the contents of this book. And at age 21, I put this author's advice into practice. I soon found what I thought were super bargains. According to Nickerson's formula, the price of an income property should equal 10 times the property's net operating income (NOI). Using this formula, I couldn't believe the fantastic deals that were coming my way. I routinely bought small apartment buildings for four to seven times NOI. I bought investment properties that, according to Nickerson's advice, should have sold for $100,000. Yet,

I paid only $50,000 to $70,000.[1] I thought to myself, "These sellers are crazy. They don't know what they're doing."

Alamo, California (San Francisco Bay Area) versus Terre Haute, Indiana

As it turned out, it was I who erred. I failed to understand that I should not have applied Nickerson's pricing formula in my hometown. Unlike Alamo, California (where Nickerson lived), my hometown of Terre Haute, Indiana, suffered a stagnant local economy and a shrinking population. Whereas Nickerson's properties typically doubled in value over a period of 10 years, mine (even after improvements) struggled to keep pace with inflation.

Income multiples relate to growth expectations.

These properties did, however, yield large positive cash flows, and because these beginning investment experiences predated the 1986 Tax Reform Act (TRA), they provided big tax write-offs. Using this tax shelter, I enjoyed virtually tax-free income from both property rent collections and my professional earnings. Nevertheless, I would definitely prefer California-sized capital gains.

Authors Neglect Economic Base

Leading gurus erroneously ignore economic base.

Why did I fail to realize the importance of economic base? Because my mentor (Nickerson), like most other authors who have penned best-selling books on real estate investing, neglected to tell his readers how to evaluate their local economies. Robert Allen merely says, "Homes and apartment buildings will always be in

[1]These figures reflect proportionality, not the actual numbers.

demand, regardless of what the economy may do. People must live somewhere; they have no choice. Housing is a basic need."[2]

Or, more recently, consider Kevin Meyers: "[Fixing and flipping], in many respects, is a recession-proof business. Regardless of the external economy, people need and want quality housing and will pay top dollar."[3] The authors of many "get rich in real estate" books completely ignore the fact that smart real estate investors study a city's economic base prior to shaping their investment strategy. Without a growing local economy, demand for rentals may sag. With a growing local economy, potential tenants multiply in number and their paychecks consistently show increased earnings. The economic pie serves up bigger slices for nearly everyone. Without a paycheck, people don't pay top dollar.

Benefit from the Lessons Learned

Some local areas stagnate. Some move ahead slowly but on an even keel. Some markets swing wildly from boom to bust and then from bust to boom. Some historically stable areas are poised for boom. Others will enter gradual decline.

To achieve success, anticipate and prepare. Batten down the hatches during storms. By the mid-1980s, for example, I saw the ominous signs of overbuilding and increasing unemployment in Dallas, Texas. I liquidated my Dallas properties near the top of the market. Conversely, increase your property holdings in cities or neighborhoods where prices do not yet incorporate the area's true potential for growth.

Profit from market downturns.

Even when you plan to fix and flip rather than improve and hold, don't set yourself up to get whipsawed by high debt and softening prices. If the economic signals flash yellow in an area where you are investing, slow down.

[2]Robert Allen, *Nothing Down* (New York: Simon & Schuster, 1980), 22.

[3]Kevin Meyers, *Buy It, Fix It, Sell It, Profit!* (Chicago: Dearborn, 1998), 2.

Temper your ambitions. Increase your cash position. Closely monitor cracks in your investment and market strategies. Create alternatives. Just as important, move quickly when the signals look promising. You are about to profit big from the next cyclical upswing.

Although the precise economic signals to watch for vary, the following list can guide you toward accurate forecasts.

- Demand: Evaluate consumer buying power

  1. Population growth
  2. Employment and incomes
  3. Costs of doing business
  4. Quality of life
  5. Wealth
  6. Community attitudes
  7. Entrepreneurial spirit

- Supply: Evaluate your potential competitors

  1. New construction
  2. Existing homes for sale
  3. Existing homes for rent
  4. Condos for sale
  5. Condos for rent
  6. Apartment vacancy rates
  7. Apartment rent levels
  8. Available buildable land
  9. Delinquencies and mortgage foreclosures

You may find talk about economic base, market signals, demand, and supply too academic. "Just tell me what I need to know to make a lot of money," you say. But that's the point. Until you check the facts about your local economy (or the local economy where you plan to invest), you're shooting blind. You may hit your target, but odds are you will not. Even when you score, don't get

too self-assured (as we all might do). While you celebrate victory, someone might change the rules of the game.

Where to Get Data

You don't need to become an economist or full-fledged market researcher to uncover population and economic data. Your local realtor, mortgage lender, and homebuilder associations regularly collect and often publish these data and similarly useful statistics. Other data sources include utility companies, the economic research bureau of a local college or state university, and your local or regional urban planning office.

Rely on your local resources.

Will the Population Grow?

Population growth (or lack thereof) results from three sources: births, mortality, and people moving into or out of an area. Try to get a good overview about your area. Look at the sources of growth or decline. Are more people moving in or moving away? How is the age distribution of the population changing?

Most people think of Florida as Heaven's waiting room, but in fact, the number of children in the state is growing quickly. Even if the number of seniors flooding into the state should slow, a long line of children will provide a consistent and increasing demand for apartments, houses, stores, and offices.

Enclaves of Existing and Potential Growth

Population growth seldom spreads itself evenly across a city or metro area. Geographic areas develop pockets or corridors of growth. Determine where the heaviest growth has occurred. Is this

Look for emerging areas.

area reaching its limit? Are the roads and freeways choked with traffic? Have rents and housing prices shot upward? Where will the next burst of population increase occur?

Find Out the Actual Numbers

The media often reports that the population growth rate of an area is slowing down. Most people interpret this statement to mean that growth *itself* is slowing. Often that's not the case. Rather, as the population base of an area gets larger, the percentage increase can fall even though the number of people moving in continues to increase.

Say that during the 1990s the population of a county jumped from 300,000 to 400,000; therefore, the decade brought an overall growth rate of 33 percent. During the 2000s, this overall growth rate is expected to fall to 25 percent. Nevertheless, even with this lower growth rate, the county population will increase by 100,000, exactly the same number of people as in the previous decade. It is the *number* of people who create demand, not the growth rate per se. Watch the numbers of people and households.

Beware of False Negatives

Look at the population growth figures for Highland Park, Texas; Washington, D.C.; or New York City. You see little upward movement during the past 30 years. Yet, housing prices and rent levels in each of these cities have climbed to rank among the highest in the United States. Why? Because these cities draw their demand from their larger metropolitan areas. To judge the total demand for housing in a specific community

Evaluate big picture influences on smaller areas.

or neighborhood, tally up the projected population growth figures for entire contiguous areas. Focus on too small an area, and you miss the big picture.

Is the Number of Jobs Increasing?

To grow and prosper, most (but not all) areas need a core of *basic* employment. Identify an area's major basic employers, the predominant types of businesses, their potential for growth, and, on the downside, whether any cutbacks, layoffs, or closings seem imminent.

Basic employers bring money into an area. When these businesses decline, so do the nonbasic businesses that feed off the revenues generated by these core firms (or government agencies and institutions). Basic employers typically include the following:

1. *Manufacturers.* To see the foundation role that manufacturers play, watch Michael Moore's movie *Roger and Me.* This documentary catalogs the economic downfall of Flint, Michigan, after General Motors closed its local Buick factory.
2. *Professional service firms.* Local lawyers, accountants, consultants, and advertising agencies count only as town fillers, not town builders. Likewise, real estate agents, stock brokers, and insurance agencies. However, some professional (or financial) service firms cater to a regional, statewide, national, or even global clientele. The billings of these firms may bring millions—even billions—of dollars into a local economy. Skidmore, Owings, and Merrill in Chicago, for example, earns architectural fees from around the world—such as the Burj Dubai—now reportedly the tallest building in the world.
3. *Medical services.* Health care has become the largest business in the United States, and undoubtedly will grow

larger as the baby boomers hit their 60s. Many areas now maintain hospitals, clinics, and testing labs that bring in patients from hundreds (or even thousands) of miles away. Think Mayo Clinic.

4. *Travel and tourism.* It seems as though nearly every urban and rural area around the world now wants to capture part of the more than $1 trillion a year that people spend on travel, tourism, conventions, and other leisure-related activities. Think McCormick Place, Disneylands, and Kenya safaris.
5. *Colleges and universities.* Many towns and cities house one or more colleges or universities that bring millions (or billions) into the local area. The Boston metropolitan area is home to more than 100 colleges and universities.
6. *Retailing/Distribution.* The Omni shopping center in Miami attracts shoppers who live in Mexico, Brazil, and Argentina. Honey Creek Mall in Terre Haute draws in shoppers from the surrounding rural areas and small towns up to 60 miles away. Neighborhood 7-Elevens contribute little to an area's economic base, but large malls, catalogue centers, and warehousing operations (such as Amazon .com, L.L. Bean) can employ hundreds or even thousands based on revenues earned from throughout the region, country, or the world.
7. *Centers of government.* Cities that house the state (provincial) capitals receive tax revenues from the residents of their respective jurisdictions, just as Washington, D.C. (Ottawa) pulls in tax dollars from throughout the United States (Canada). Other cities earn revenues from the state and federal agencies, military bases, defense contractors, and hospitals.

Look for areas of job growth.

Few small investors pay much attention to their area's basic employment—unless their economy has already turned into recession. When the Southern California economy boomed

in the late 1980s, real estate investors and homebuyers alike thought those 10 to 20 percent a year property appreciation rates would last forever. When the Berlin Wall fell in 1989, few property owners or potential buyers could see any implications for San Diego home prices, apartment rents, shopping malls, and office buildings.

What Was the San Diego Connection?

Defense spending. Defense contractors counted among the largest basic employers in Southern California. After the Berlin Wall fell, Congress slashed defense spending. Defense contractors had to cut back tens of thousands of jobs. In addition, Congress severely reduced the number of personnel stationed at the San Diego Naval Base.

As unemployment went up, housing demand and housing prices (rent levels) fell. Nearly everyone connected with real estate began to feel the effects. Homebuilders shut down construction sites. Real estate agents, home inspectors, property lawyers, title insurers, and apartment managers experienced cuts in income. Retailers lost customers. Office buildings emptied out as businesses laid off workers.

Forecasting Recovery

At that time, I was living in Berkeley, California, and frequently flew down to San Diego (La Jolla) for weekend excursions. I kept my eye on market signals firsthand. By the mid-1990s, everything was in place. The market bottom was clear. Population and job growth were moving up. Mortgage lenders were making it easier to borrow. That's when I wrote, "By the year 2001, renters throughout Southern California will sorely regret the housing bargains they missed during the mid 1990s."[4]

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[4]Gary W. Eldred, *Stop Renting Now* (NIHO, 1996), 161.

Yet, as of 1996, the so-called real estate expert for the *San Francisco Examiner* wrote, "A home is where the bad investment is" (November 17, 1996). And another California expert wrote, "The quick buck profits [in real estate] are long gone.... Buying a property in excellent condition and hoping somehow to earn a profit is a no-win situation" (*San Diego Union-Tribune,* September 8, 1996).

Profit from reading market signals.

Why did I see what others failed to notice? Because I know how to read and weigh market signals. And that's a skill you should learn. Most people merely extend the present or recent past into the future. That's why in the late 1990s stock enthusiasts forecasted stock market gains of 10 to 15 percent annually. Do you recall the bestselling books *Dow 36,000* (Glassman and Hassett, Times Business Books, 1999) and *Stocks for the Long Run,* 2nd ed. (Siegel, McGraw-Hill, 1998)?

No one can forecast exactly when and by how much prices or rents will increase or decrease. However, you need not aim precisely. If you monitor fundamentals and temper your strategy accordingly, you will outperform the majority of investors, and your properties will outappreciate the average.

Cost of Running a Business

Why did the old-time New England textile manufacturers move their factories to the South? Why did many Silicon Valley technology firms move operations to Austin, Texas? Why did my publisher, John Wiley & Sons, Inc., give up its long-time world headquarters at 605 Third Avenue, New York City, in favor of a new office complex just across the Hudson River in Hoboken, New Jersey? Why do business analysts forecast huge growth in warehousing and distribution employment along the I–4 corridor that links Daytona

Beach, Orlando, and Tampa–St. Petersburg? Costs. Lower costs of running a business.

Businesses and Employment Migrate to Lower-Cost Cities, States, and Countries

In the highly competitive national and global marketplace, major firms persistently scout for business locations that will reduce their costs of labor, transportation, real estate, energy, and taxes. In addition, they look to see what kinds of incentives government(s) might provide, such as worker training, low-interest financing, and tax abatements.

At times, this search may encourage a move from the central business core to the suburbs, or perhaps across state lines to a more tax-friendly environment. On other occasions, the move may take the firm's jobs to a different country. Overall, size up the relative cost competitiveness of the area(s) where you plan to invest. Do you think that its cost structure (on balance) will encourage employers to move in—or push them to move out?

Look for areas that attract new businesses.

Cost of Living for Employees

Firms view an area's cost of living for their employees. The quip in Silicon Valley: "What do you call an engineer who earns $150,000 a year?" Answer: A renter. Given the high living costs (especially housing prices, but also California's state income taxes, traffic congestion, and auto and homeowner's insurance), Silicon Valley firms will need to find alternative locations that provide a more affordable lifestyle for employees.

In the past, Salt Lake City, Seattle, and Austin were able to capitalize on the fact that they gave employees lower living costs. While still true to a degree (relative to the San Francisco Bay Area

and Silicon Valley), these cities can no longer offer the clear-cut advantages they displayed in the early 1990s. The question now becomes: Where are the hot spots for tech (or other employment) that will grow strongly in the future? Dubai, Bangalore, Saigon?

Quality of Life

Today, more and more people choose the cities where they will work for quality of life (QOL). Executives evaluate new locations on the basis of climate, recreational amenities, school systems, cultural facilities, municipal services, crime rates, housing costs, and traffic flow.

Communities that seek growth try to build their quality of life images. A passage from an Edmonton, Alberta, economic brochure reads as follows:

> The distinct seasons enjoyed by Edmontonians are indicative of the recreational activities available. Summers are warm, with daytime temperatures averaging 22°C (72°F) and evening temperatures cooling to a pleasant 15°C (60°F). Summer is complemented by a mild spring and autumn, as well as plenty of sunshine, making much of the year enjoyable for hiking, cycling, trail riding, golf, tennis, and camping. Bicycle and hiking trails in the city's Capital City Park are linked by four pedestrian footbridges across the North Saskatchewan River. Along this river valley are adjacent golf courses, boat launches, picnic sites, and a beautiful network of trails. Winters are characterized by clear blue skies, low humidity, and very little wind. The coldest month is January, the average high being −10°C (16°F) and the average low being −18°C (0°F). With crisp winter temperatures and an average annual snowfall of 140 cm (55 in), Edmonton is an ideal city

for winter sport enthusiasts. In the winter, the hiking trails are converted to accommodate snow-shoeing and cross-country skiing. In addition to the river trails, many other fine cross-country ski trails and downhill facilities are located within, or in close proximity to, Edmonton.

To complement the pleasant summers and invigorating winters, Edmonton offers virtually pollution-free and pollen-free air.

Edmonton is a city to be enjoyed by all, for all seasons.

Does that picture arouse your desire to seek a job or start a business in Edmonton? The city leaders hope so, for during the coming years the cities that achieve economic growth will be those that can sell their advantages as a good place to raise a family and enjoy life. How does your area rate? What serious efforts, if any, are being made to improve it?

Invest in areas with high QOL.

Quality of Life Also Attracts Wealth

Survey people who have bought property in Aspen, Colorado; Jackson Hole, Wyoming; Longboat Key, Florida; Ashland, Oregon; or Sedona, Arizona. Often, they're not the people who hold jobs in those areas. Rather, they're people with relatively high incomes or wealth who choose where they want to live or maintain a second home. Many high-income free agents such as writers, consultants, inventors, and entrepreneurs also enjoy both the money and occupational freedom to live wherever they want.

Where will boomers migrate?

Those cities, towns, and rural areas that appeal to the footloose and financially mobile

will continue to experience high demand for properties. This trend will continue. As boomers head into retirement, as the Internet (and intranet) revolution permits increasing numbers of people to work from home—no matter where that home is located—people will abandon high-cost, low-quality-of-life areas in favor of those locations where they prefer to live. Will your area attract these folks?

Community Attitudes and Actions

Another factor that boosts demand and explains why properties in some areas appreciate faster than in others is community attitudes. Do city leaders *want* economic growth?

Surprisingly, in some states and cities, the answer to this question is "No." Sometimes local business or government leaders discourage new firms from locating in an area as a way to protect vested interests. Sometimes local politicians develop a power base that they do not want outsiders to challenge. The local citizenry may want to preserve a way of life.[5] Through elected and appointed officials, they make it difficult for new firms to obtain permits, licenses, and zoning approval.[6] In the past—and especially in towns dominated by one or at most several major employers—powerful owners of existing firms have successfully kept new industry out of an area. Their chief reason has been to avoid additional bidders for available workers and thereby maintain low-wage rates.

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[5]During the late 1970s, Oregon opposed economic growth quite loudly, even to the extent of advertising Oregon as a state where newcomers were not welcome. By 1984, though, political leaders and citizens had changed their tune. Badly hurt by the recession of 1981–82 and still slow to recover, Oregon went out to recruit new industry.

[6]Recently, the city politicians in Terre Haute turned away 400 high-paying jobs because local power brokers opposed the company (a major chemical manufacturer).

In cities that want economic growth, firms and private organizations, as well as various government officials, actively recruit investment and new employers. The Jacksonville, Florida, Chamber of Commerce hired a national consulting firm to prepare a comprehensive economic analysis of that city. The study identified the types of employers whose needs would best match Jacksonville's strengths. The consultant recommended ways that Jacksonville could improve the marketing of the city to targeted employers. Two rapid growth areas in North America have been Calgary and Edmonton, Alberta, Canada. Although their economies have benefited greatly from the well-endowed resource base of Alberta (especially oil), the pro-business, pro-growth attitude of the provincial and city governments also contributes. In Canada, a country where left-leaning political attitudes tend to dominate, Alberta boasts its reputation for free enterprise.

Entrepreneurial Spirit

In a widely recognized study conducted for the Population Reference Bureau, Professor Jeanne Biggar traced the shifts in population that the United States has experienced since 1970. She noted that 15 Sunbelt states accounted for nearly two-thirds of America's population growth. Biggar pointed out, however, that the real meaning of these shifts was not so much the number of people who were moving to the South and West; instead, it was the *quality* of those who migrated that held ominous implications for the older cities. "The North," Professor Biggar noted, "is losing the able youth who might be most likely to provide the creative ideas and enthusiastic leadership needed to tackle the problems associated with deteriorating cities." In other words, those individuals who approach life with what we refer to as the *entrepreneurial advantage.*

Many cities are *not* declining because they are losing their economic base; they are losing their economic base because they

Look for areas rich in entrepreneurial talent.

are losing the individuals who could breathe life into their economies. No city, state, or country can create or sustain prosperity unless it nourishes individuals who remain alert to changing markets, who can discover opportunities, and who can combine resources in new and better ways to meet the needs of others.

Progress depends on people. Regardless how long the list of an area's economic advantages and disadvantages, in the end an area's prosperity will largely result from the drive of its people. Do the people who live in an area, or are moving into the area, display the entrepreneurial spirit?

Concluding Remarks

When I began to buy properties in my hometown, I knew nothing about the city's economic base. Quite likely, I couldn't have told you what the term *economic base* meant. But now I have witnessed booms and busts in Las Vegas, Miami, Dallas, San Diego, and Vancouver, Canada. I know that a strong local economy can turn property owners into multimillionaires. I also know that a downward slide, even when temporary, can turn unprepared investors upside down.

Even if you're a short-term fix and flipper, monitor your area's basic sources of jobs, income, and wealth. If the economic signals start flashing yellow, pay attention. Don't think you can blindly speed through without danger.

Focus on cities, communities, and neighborhoods that reveal promise.

Use knowledge of economic base to select areas and communities that show the most promise. Discover those cities, suburbs, or even neighborhoods that will experience high rates of growing demand over the next 5, 10, or 15 years. Had I understood the basics of what I have laid out for you in this chapter at the start

of my career, I would have chosen to invest somewhere other than Terre Haute. Or, perhaps I would have targeted a more promising part of the Terre Haute urban area than those neighborhoods where I actually did buy. At least, I would have recognized that my early properties were unlikely to achieve the same rates of appreciation as those of William Nickerson. Properties—even within the same metro area—rarely grow in value at the same pace. Those properties appreciate fastest where growing demand pushes against a constrained supply. Before you invest, follow the advice of Harold Hill (the *Music Man*)—"You gotta know the territory."

CHAPTER 4

Outperform the Competition

You have found one or more geographic areas where the local economic base looks stable, strong, and growing. Now, size up the competition. A competitive survey pays big dividends because the majority of investors rarely travel around to inventory, inspect, compliment, and critique competing properties.

In fact, most property owners never even ask for comments and/or critiques from their own tenants and prospects. As a result, they misprice their units, fail to make the best profit-enhancing improvements, ignore innovation, and, in general, operate their properties with subpar performance. Fortunately, such subpar management spells profit potential for you.

The Competitive Battle

Winning coaches study opposing teams.

Think of it like this. You're a football coach. Your team won a spot in the playoffs. Would you increase the quality and effectiveness of your game strategy if you watched the game films of other teams? Should you watch your own team's game films and critically look for

ways to improve? Every winning coach learns the strengths and weaknesses of his own team as well as those of his competitors. This same principle holds true in real estate. Study competing properties in detail; then craft a game strategy to outperform them.

Four Good Reasons to Inventory, Inspect, and Critically Review Competitors

To maximize profits, create a value proposition that tenants (buyers) prefer. Studying competitors helps you craft this profitable strategy in four ways:

1. Select the best area in which to invest.
2. Use market information to negotiate with sellers.
3. Learn the strengths and weaknesses of competitors such that you can wow your tenants with a more appealing combination of features, services, benefits, and pricing.
4. Develop reliable property appraisals and financial pro formas.

Where to Invest

Your economic base analyses reveal areas of employment stability, strength, and population growth. You're looking for people with regular paychecks or other steady sources of income and wealth. But the other side of demand is supply. When too many investors, developers, and homebuilders enter the same territory, they bid up prices of newly constructed buildings and developments. Sooner or later, the market is awash in product. Vacancies shoot up. Property prices and rent levels fall.

History Repeats Itself Texas in the early to mid-1980s serves as Exhibit No. 1 to illustrate how oversupply destroys profitability. Then (as now), Texas was a bright star for economic growth, but Texas real estate developers went wild in speculative building. Between 1980 and 1985, they threw up hundreds of thousands of apartments, office buildings, strip malls, and condo projects. Even without the collapse of oil prices, the Texas property market could not possibly have absorbed all of this new construction at prices and rent levels high enough to turn a profit.

Factor potential overbuilding into your risk and revenue projections.

As a Texas investor at the time, I fortunately saw this oversupply coming onstream and liquidated my portfolio of Texas properties one year prior to the peak. Although I would like to claim uncommonly shrewd market analysis, that boast overstates the truth. In that instance, anyone who paid attention to the housing starts, job growth, and population could have forecasted a serious downturn in the market. No special skills necessary.

Learn from the Texas Experience Since the disastrous overbuilding of the 1980s, construction lenders supposedly tightened their lending practices. But that tightening didn't last. (It never does.)

Periodically, overbuilding still pushes growth markets into down cycles. As I write, both the Miami and Las Vegas markets show massive amounts of recent construction. If I were buying in either of these areas right now, I would pick neighborhoods and market niches carefully. I would look for pockets of market opportunity that could withstand the increasing competition, concessions, and price cutting.

I would buy only those properties that are bargain-priced and ripe for value-enhancing improvements. When market signals such as inventory buildups of unsold houses and condos, rent concessions, and rising vacancies flash yellow, tap the brakes, slow down, and look cautiously.

Overbuilding soon turns into shortages.

Buy When the Blood Is Running in the Streets Back off at the early stages of oversupply. But as vacancy rates, rent levels, and prices deteriorate, buy. During the early 1990s, you could have hung the Homes for Sale classified ad section of the *Dallas Morning News* on the wall; then, to select properties, throw darts. In that depressed housing market (yet still backed up by strong economic and population growth), nearly any real estate investment strategy would have paid off with outsized returns. Likewise for the San Diego (or the Inland Empire) housing markets of the mid-1990s.

Monitor markets poised for growth—but currently swamped with oversupply. Once again, investors who step in and clean up the mess when others see nothing but despair will look back 5 to 10 years from now and brag about the terrific bargains they negotiated while the media and Chicken Littles fretted about the end of real estate.

Market Information Gives You Negotiating Power and Confidence

When you shop to buy investment properties, most sellers give you a rent roll that ostensibly confirms the rents they are collecting from their tenants. Can you believe these rent figures? Maybe, maybe not. Should you rely on these figures to calculate your purchase price and future cash flows? Absolutely not!

To negotiate with power and confidence, you must never, never, never—do I make myself clear?—*never* rely on the rental income or expense figures that sellers or their real estate agents hand you. You must always work up your own figures based on firsthand knowledge of competitors. You gain this knowledge only when you look at a broad sampling of properties for rent, detail their characteristics and rental rates, and then keep tabs to see how quickly various types of units rent up.

Rely on your own numbers, not the sellers'.

Sellers' Figures: Too High or Too Low Sellers often overstate their rent collections. To negotiate effectively, use your firsthand market data to gently inform the seller that you're not buying his make-believe world. Even if the figures were true, a higher than market rent level will probably create more tenant turnover and higher vacancies. Higher than market rents (without unique features and benefits) don't necessarily lead to higher profits.

On some occasions, sellers who lack good market knowledge will charge rents that sit below market. In that case, calculate your bid price according to the seller's figures. Use your knowledge of the market to gain confidence that you're negotiating a great buy (subject, naturally, to due diligence property inspections and verification of the rent roll).

"You Can Easily Raise the Rents" Many sellers will show you their ostensibly below-market rents and then add, "But I deserve a much higher price because after you take over the property you can easily raise the rents." Reject this ploy.

Tell the seller that you'll pay for the current operations of the property. You're looking for an investment, not a speculation. "Of course, Mr. Seller, if you're willing to provide a rent guarantee of those higher amounts over the next five years, perhaps we could price the property using a larger income stream." Unless you do see huge upside potential that extends beyond the seller's figures, pay only for the present. Reserve the upside as a reward for your entrepreneurial efforts. (Of course, this guide implies that you will earn higher returns, but you will sift through more properties to find those bargains.)

Pay for the present, not the future.

Searching for a Preferred Value Proposition (PVP)

After you gain ownership of an investment property, you improve its operations and market strategy. But how can you learn which

improvements offer the most profitable competitive edge? Conduct a competitive market analysis (CMA).

As you inspect and evaluate the properties that are available, record each detail that prospective tenants would like or dislike. Look for the advantages and disadvantages of properties. As you take note of these features, attributes, turn-ons and turn-offs, formulate your own strategic action list of do's and don'ts. With your superior knowledge of competing properties, differentiate your units from those offered by other investors. Your target market of tenants will see (given the quality of your promotion) that you offer the value proposition they prefer (the PVP).

Constructing Your Financial Pro Formas

You do not buy properties merely to wow your tenants with an outstanding product. You want to make money.

Your CMA leads you to big-profit improvements.

Your competitive market analysis (CMA) alerts you to the profitable improvements that you can implement, and it steers you clear of those grandiose plans that tenants would not pay for. If your CMA shows that neighborhood rents for two-bedroom units typically range between $700 and $850 per month, $850 sets the maximum rent that you're going to be able to collect. Forget the Jacuzzi, the granite countertops, and the Sub-Zero refrigerator. These improvements won't pay back profitably.

Often, beginning investors (and homeowners) get carried away with their property upgrades only to learn that they've put more money into their improvements than the market (tenants or buyers) will bear. When you temper your plans against the reality of competitive pricing, you strike that profitable balance between too little and too much. Your CMA answers the important question: "If I make these improvements, how much more will tenants pay each month for these units?"

Your target market operates within a budget. When you construct your financial pro formas for future rent collections, capital outlays, and expenses, realistically weigh inflows against outflows. Price your units in the context of the market. Provide your tenants with the best deal they can get for the amount of money they are willing and able to pay.

Identify Your Competitors

In a narrow sense, your property will face competition from similarly priced properties that are located in the same neighborhood or trade area. But realistically, your competitors may include properties in other areas of town. Apartments also compete with houses, co-ops, and condominiums that are offered as rentals. In addition, many apartment buildings face competition from home ownership (single-family houses, co-ops, or condominiums). In fact, during the years 2000 to 2006, apartment rent levels and occupancy rates suffered because low interest rates and easy qualifier mortgages enticed millions of renters into buying their own homes. "Why rent when you can own?" became the competitive sales pitch of real estate agents and homebuilders.

Your competitors may sit across the street, or across town.

Quickly Adapt to Change

When you identify potential competitors, answer the question "What other properties and types of properties might attract the same types of tenants that I'm aiming for?" Then stay abreast of the features and pricing of these alternatives.

If a new 200-unit condo project comes onto the market with "zero-down financing and payments less than rent," quickly fire off

Give your tenants the best deal they can find.

a competitive response. Otherwise, your units will incur more turnover, higher vacancies, and tenant resistance to rent increases. Most people and businesses shop and compare. They look for their best deal wherever they can find it. Change your strategy as the relative prices and rent levels of houses, apartments, and condos change.

Monitor the market. You won't get blindsided when competition heats up—no matter where or what type of property creates the competitive pressure.

When Markets Tighten

In the short run, competition can make it more difficult for you to generate strong operating profits. Over the long run, you will undoubtedly benefit from the general trend of inflation and increasing rents. Over time, monitor rent levels, vacancies, and prices; your knowledge of the market helps you quickly set rents at higher levels as demand increases. Owners who do not monitor the market tend to overprice themselves out of soft markets, and they fail to adjust their rents upward when the market turns in their favor.

Some property owners increase their rents by 4 or 5 percent every year. In practice, this policy will not maximize profits. In slow markets, vacancies increase and tenant quality deteriorates. In tight markets, rents lag. In either type of market, the competitive ignorance of property owners leads to lower performance than they could otherwise achieve.

More Practical Implications

During the early 2000s, when home prices shot up and apartment rents weakened, tenants asked themselves, "Why pay $1,000 a month in rent when for that monthly payment (after our tax

High home prices will force more people to rent.

deduction) we could buy a $250,000 house?" But now, many tenants can no longer afford to buy. Renting looks more affordable. If (when) mortgage interest rates climb higher, millions of potential homebuyers will continue renting. Investors who first notice this shift can position themselves to take advantage of it. The next three to five years will show stronger rental markets and concurrently increasing prices for investment multifamily properties.

What to Look For: The Location

When you evaluate and compare competitive properties, detail the features of their respective locations. Superficially, you might categorically rate locations as, say, excellent, good, okay, or "let's get out of here." But savvy investors go deeper. Location actually includes dozens of ingredients that influence rentability. As a minimum, consider the following:

- Aesthetics
- School districts
- Property taxes and services
- Crime rates
- Accessibility
- Trendiness
- Public transportation
- Neighborhood residents (existing and newcomers)

Location refers to a variety of attributes.

You will discover significant locational differences (both favorable and unfavorable). When you do, adjust your estimate of tenant appeal either up or down accordingly. Isolate each difference; otherwise, you may miss a feature that provides a competitive advantage or disadvantage.

Aesthetics

To identify the features of a neighborhood, drive the streets slowly. Get out of your car and walk about. Focus attention on the neighborhood's attractiveness. Talk with residents. What do they like or dislike? Search for answers to questions such as these:

1. *Noise.* Does the neighborhood suffer from any undue traffic noise, airport flight paths, industrial sounds, or other disturbances (loud barking dogs, nearby construction, and so on)?
2. *Upkeep.* Do owners and tenants maintain their properties? Do homes and apartment buildings sparkle with pride of ownership, or do many properties need paint and yard maintenance?
3. *Parking.* Are the streets relatively free of cars, or does the neighborhood lack sufficient off-street driveways and garages? Worse yet, do you see cars parked in yards? (Neighborhoods heavy with student rentals sometimes display this type of eyesore.)
4. *Bad mix.* Does the neighborhood abut or merge into any commercial, industrial, or otherwise incompatible land uses? Do you notice unsightly vacant lots and run-down or boarded-up properties?
5. *Views.* Do neighborhood residents enjoy pleasant views of lakes, parks, woods, bays, or mountains?
6. *Overall feel.* What's your feel of the neighborhood? Does it seem to be moving up, stable, or moving down?

School Districts

If tenant households include school-age children, school district quality can boost or retard rental rates. Investigate this feature. You need not buy an investment property in the best—or even

Less prestigious school districts often make good investments.

a good—school district. It depends on relative prices, rent levels, and the types of tenants you hope to attract to your property.

Frequently, it's wise to avoid properties in top school districts because investors and homebuyers bid prices up too high. Sometimes it makes sense to sacrifice an unknown amount of future appreciation in favor of more cash flow today. Work the numbers in your area for yourself. What is true in one city or neighborhood might not stand true elsewhere. Nevertheless, look at the less prestigious school districts. In many cities, fewer than 20 percent of rental households include school-age children. You might profitably target students, roommates, empty nesters, or seniors—none of whom care much about school quality per se.

Property Taxes and Services

High property taxes can eat into rent receipts. However, before you rule out a neighborhood with high property taxes, compare government services. High property taxes undermine values only when area residents don't receive a commensurate high level of government benefits. In addition to schools, government services may provide parks, recreation areas, golf courses, community colleges, trash collection, water supply, sewers, as well as police, fire, and other protective services.

Should you find that two competitive properties are subject to different amounts of property taxes, look further. You may also find that they differ in their level of municipal and county services. In some instances, you may discover that districts with lower property taxes offer a higher level of services. In any event, realize that tenants of some buildings enjoy a level of government services that aren't available to the tenants in other areas. Rental rates can reflect this difference.

Find out whether government services match the taxes you will pay.

Crime Rates

Naturally, people want to feel safe in their apartments and on their neighborhood streets. Low crime makes for higher property values and monthly rents, but it's not just the quantity of crimes that counts. More important is the type of crime. Drug dealing, gang shootouts, and house break-ins weigh much differently than occasional car thefts or those domestic squabbles that bring in the police.

Often, too, perceptions of neighborhood crime overstate reality. Check facts with the police. Statistical reporting areas may not accurately apply to various submarket neighborhoods. Beware of generalizations. Pinpoint actual street boundaries that delineate high-crime areas. Sometimes you can locate pockets of safety. As good people flee to this oasis, rents and property values go up.

Accessibility

How quickly and surely can you travel from a neighborhood to job centers, shopping, professional services, recreation areas, schools, colleges, and cultural facilities? Are streets often congested? Does most to-and-from traffic flow through a nightmare-type interchange (such as Atlanta's famous spaghetti junction, perhaps more aptly named malfunction junction)? Do frequent auto accidents leave traffic stalled? What about tolls? They can mount up. Is the neighborhood served by just one bridge, or numerous ways in and out? Tenants typically value convenience even more than most homeowners (who migrate to suburbia).

Trendiness

For some tenant segments, trendiness has become a much sought-after feature. How does the neighborhood rate for coffee houses, ethnic restaurants, bookstores, and movie theaters (especially

those that show foreign and independent films)? The advertising come-on, "Walk to chic shops, restaurants, and cafes," will bring a nice rent premium for properties that offer this desirable convenience. If the neighborhood lacks these trendy places now, do any signs indicate their arrival? Has Panera Bread (or other hot concept restaurants) shown interest in the area?

Public Transportation

In some cities, apartment buildings within convenient walking distance of a commuter train (or subway) station rent for as much as 5 to 10 percent more than comparable units located farther away. Rental units near bus stops don't typically command the price premium they used to but for some tenants, this feature proves to be an advantage they will pay for. As for other types of public transportation (taxis, airports, ferries, limousine service), easy availability may or may not affect a property's rent levels. Learn the tenant and homebuyer market to know for sure.

Who Are the Residents and Recent Homebuyers and Tenants?

When you compare locations (neighborhoods), learn who lives there now and who's moving in. What are their professions, educations, ages, incomes, lifestyles, races, religions, and family sizes? Though it's true that fair housing laws bar discrimination, it's obvious that few neighborhoods perfectly mirror demographic diversity. Today we find considerable voluntary congregation of Blacks, Latinos, Jews, Asians, seniors, young urban professionals, and various other demographic segments.

Who's moving in? Who's moving out?

Many racial and ethnic changes push neighborhood values up—not down. People influence rent levels and property values. Although fair housing laws forbid real estate agents and property

managers from taking notice of the racial, ethnic, and religious characteristics of neighborhoods, investors need not ignore reality.

Are neighborhood properties primarily occupied by owners or renters? As with race, ethnicity, and religion, you can't judge owners or renters as better or worse. Instead, what are the implications for a property's rental rates? In neighborhoods that experience gentrification, for example, you find younger, upscale renters displacing moderate-income homeowners. Nevertheless, I prefer to buy multi-unit buildings in predominantly single-family neighborhoods—if I can buy at a reasonable price. Likewise, condo units in buildings with higher owner occupancy tend to rent for a higher price than condo buildings that are flooded with renters.

Site Features

Note appealing features such as landscaping, yard care, spacious grounds, on-site parking, fencing, and amenities such as swimming pools, tennis courts, a clubhouse, or a fitness center.

In viewing the site and site amenities, identify attractive features that stand in short supply; when you enter the market to buy, you'll recognize those features that place a property at a competitive advantage or disadvantage. Of course, this same principle applies to the exteriors and interiors of properties.

The Exterior of the Building

As you inspect the exteriors of various competitive properties, notice aesthetics, state of repair, construction materials such as brick, block, or frame, number of stories, and architectural style.

Do competitors maintain their properties?

Do the buildings seem modern and functional or outdated? Notice points of access to the units. Can tenants park reasonably close to the building or rental unit entry points? How much curb appeal do the buildings and grounds show? Does the property condition invite potential tenants to come in and take a look? Or would it encourage prospects to drive up, take one glance, and drive right off?

Would the property raise security issues with potential tenants? Are first-floor windows protected by security screens or other preventive measures? Are parking areas, walkways, and building entrances well lighted?

Remember—view competing properties through the eyes of potential tenants. Investors often disregard the actual appeal and livability of properties. They unduly focus on rents and expenses. Even though rents and expenses do determine the bottom line, it is the appeal of the property from the tenants' perspective that accounts for the figures that work themselves down to that bottom line.

Play the Tenant

By *play the tenant,* I mean go through the basic search process just as a real tenant would. Read rental ads. Call to make a further inquiry. Go out and look at the actual houses and apartments that are currently available for rent. Learn about the various tenant application procedures, leases, and security deposits that owners and managers use. Evaluate the marketing effort including the quality of the advertising, the professionalism of the showing, and any follow-up activities.

With this information, differentiate property owners (managers) who get their properties rented from those whose units remain on the market. When you look at units and talk with rental

agents, you gain knowledge that leads to a wealth-building market strategy.

Inspect the Interiors of Competing Units

With pleasing grounds and a good building exterior, owners draw tenants in to look at their units; however, without a pleasing interior, most good tenants will search elsewhere. What features contribute to a pleasing interior? Many of those same features attracted you to your current home.

- Aesthetics
- Livability: unit size, room count, and floor plan
- Low energy costs

Aesthetics: How Does the Unit Look, Feel, and Sound?

"I was once in a home," recalls real estate appraiser Dodge Woodson, "that made me feel as if there should have been a coffin sitting in the living room. The drapes were dark and heavy—a ghastly green that gave me an eerie feeling. I don't spook easily, and I'm used to seeing a lot of homes in a lot of different conditions, but this home made me uncomfortable. If I had been a prospective buyer or tenant, I would not have been able to focus on anything but the drapes."

Rental units should display emotional appeal.

Woodson's reaction to the eerie dark green drapes wouldn't have surprised Professor Mary Jasmosli of George Washington University. Jasmosli has developed an expertise she calls *environmental sensitivity*. Through her research she found that people react emotionally to interior living areas in ways that they themselves

can neither explain nor understand. "Features such as number of windows, window treatments, color schemes, views, placement of walls and doorways, room size, ceiling height, cleanliness, and the amount of light all hold special meaning," reports Jasmosli.

Now, return to Dodge Woodson. "The next time I entered that home, I couldn't believe the difference," he remarks. "The owners had replaced the dark green drapes with flowing white window treatments.... Not only was the living area pretty, it appeared much larger.... I noticed features that I had never seen before. The rooms were alive with light. This experience convinced me of the power that window treatments have."

Critique the emotional impact of the living areas that you inspect. Notice everything from window treatments to ceiling heights, from color schemes to the placement of walls and doorways. Will potential tenants react as Dodge Woodson did on his first visit to the home he describes, or will they respond more as he did on his second visit?

Livability: Unit Size, Room Count, and Floor Plan

How about floor plan? Does the layout of the living area offer convenience and privacy? Does it work efficiently?

When you approach the main entry, do you have to climb steep steps? Is there a covered area so visitors can avoid standing in the rain or snow while waiting for someone inside to answer their knock? If the main entrance lies below grade, does it appear that water may build up in the entrance area? As you walk in the front door, notice whether you're dropped immediately into a living area or if the unit has a foyer. Is there an adequate coat closet nearby? Relative to the main entrance, where is the kitchen located? Can you walk from the entry door to other rooms of the unit without passing through a third room? How are the locations and sizes of bedrooms, baths, and closets?

Livability generates higher rents and lower turnover.

Imagine tenants living in the apartment. Where will their kids play, both indoors and outdoors? Will the parents be able to keep an eye on them? If you're looking at a larger-sized unit, does it have a Grand Central Station-type living room, or is this room pleasantly isolated from other activity areas?

Go into the kitchen. How long does it take the faucet to draw hot water? For purposes of work efficiency, can someone step conveniently back and forth between the refrigerator, oven, stovetop, and sink? Do you see adequate counter and cabinet space? How much natural and artificial light is there? Is there an eat-in kitchen area that separates the household members who are eating from those who are working (preparing meals, cleaning up)? Can someone conveniently enter the kitchen from the parking area while carrying several bags of groceries?

Noise is a potential problem within many rental units. Does sound from a television or stereo carry into other rooms? Bring along a radio on your inspections. Place it in various rooms. Turn the volume up. Do the walls provide enough soundproofing? Roommate-type tenants want privacy and quiet. If a property fails to offer these essentials, it will lose tenants and rents.

Will tenants be able to hear neighbors or neighborhood noise from inside the unit? Tenants pay for quiet. They discount for noise.

Although neighbors and neighborhood noise are especially important in neighborhoods filled with apartment buildings, predominantly single-family neighborhoods are no strangers to loud stereos, barking dogs, and Indy 500 engine revving. Don't just assume that the neighborhood offers peace and quiet to a building's tenants. Verify peace and quiet with the property's owner, manager, or current residents.

Energy Costs

When you view competitive units, inquire about utility bills in two ways. Who pays what? How energy efficient is the unit?

Tenants flee rental units with high-cost utilities.

Who Pays What? Although most property owners today avoid "all bills paid" types of rental buildings, owners often do pay water, sewer, cable, heat, trash collection, or some combination thereof. To compare rental units and their respective rent levels fairly, know which, if any, utility bills are included in the monthly rent figure. In colder climates, for example, a rent of $1,000 per month that covers heating costs could actually prove lower cost than another unit that rents for $950 a month—no bills paid.

How Energy Efficient Are the Units? Energy efficiency affects the rentability of rental units in two ways. One way is comfort. Units that lack good insulation dissipate heat or air conditioning quickly, causing uncomfortable changes in temperatures, cold air, drafts, and possibly hot spots. The other way is cost. Poor insulation and energy-guzzling HVAC and appliances send utility bills through the roof.

Either or both of these features increase tenant turnover, vacancies, and rent levels. Smart tenants verify energy efficiency before they sign a lease. Seek answers about energy efficiency. Examine the HVAC and hot water units. Check the windows and exterior doors for drafts. Ask current tenants about their comfort level and the size of their heat, hot water, and cooling bills.

The Rental Process

When tenants shop for a place to live (to an extent greater than most property owners realize), their choices are also influenced by the total rental process. This process typically starts with the advertising of the units and extends through the application procedures, the amount of the required security deposit, the specific terms of the rental agreement, including the personality

Application and leasing persuade (or repel) tenant choice.

and professionalism (or lack thereof) of the person who answers telephone calls from prospective tenants, shows the units, and invites the application.

As you size up competitors, evaluate the total rental process that property owners and managers follow. Discover the advantages that give your properties a competitive edge—wherever you can find them.

Because few owners permit pets, maybe you should allow them. When nearly all owners require a 12-month lease, maybe you could profit by permitting shorter terms. When most owners advertise with vague, basic information, you can gain tenant interest for your units with a more appealing sales message.

We return to the rental process in a later chapter. But realize, this process enhances (or scales down) the relative appeal and desirability of units. As you survey properties, add these data to your competitive checklist.

CHAPTER 5

Choose the Best Target Market

Let's review where we've been and where we're going. Study the economic base of an area, conduct a competitive market analysis, and craft a market strategy that gives your properties a competitive advantage over other property owners. You want to provide a preferred value proposition (PVP) to a select type of tenant. When such tenants look at one of your units, you want them to shout, "Wow! We'll take it. We'll pay whatever you're asking!"

Okay, I'm dreaming. But you get the idea. With a well-crafted value proposition, you quickly fill vacancies, reduce turnover, and increase your net operating income.

How to Create a PVP

How can you achieve a PVP? Execute these six steps:

1. Survey the strength of the pertinent market area(s) for population growth, jobs, income, wealth, quality of life, number of residential listings for sale and for rent, market values, apartment rent levels, vacancy rates, and other market signals.

2. Inspect and compare competing houses, apartments, and condos that currently attract (or might attract) the type of people who might make up your target market.
3. After your market survey leads you to one or more promising geographic areas, select a target market of tenants. Learn the preferences and budgets of these potential renters (the topic of this chapter).
4. Buy a property that you think *could* stand superior to competitors in the eyes of these tenants.
5. Plan, design, and execute an improvement program for this property.
6. Develop a value proposition along with a low-cost, highly effective campaign to sell, trade, or lease the property.

What does nearly every business in the country want? Less competition! What kind of markets do most property owners face? Highly competitive. Even small towns and cities offer homebuyers and renters hundreds, if not thousands, of choices. How can you consistently earn extraordinary profits in a market filled with tenant choices? Cater to a distinct market with uniquely desirable property features.

Establish a competitive advantage through target marketing.

When you choose a target market and craft your strategy, tenant demand for your properties will significantly exceed those generic competing properties. In fact, those competing properties won't seem comparable at all to the market segment of tenants to whom you choose to offer a preferred value proposition.

Diversity Rules

The term *diversity* embraces not only gender, race, and religious beliefs. It also includes a panorama of demographics and

psychographics (emotional feelings, preferences, and attitudes). When you contemplate how people differ across a range of characteristics, you can zero in on a select bull's eye of tenant customers.

Demographic Differences

Think about the following list of demographic characteristics. Can you see how a property owner might use one or more of these attributes to help segment a market? With these attributes in mind, craft a strategy to meet a motivating need, want, or problem of this potential market.

- Age
- Years of schooling
- Sex
- Occupation/employer
- Height
- Weight
- Health/disability
- Geographic location
- Household size
- Household composition
- Income/credit score
- Wealth/cash savings
- Stage of life
- Religion
- Ethnicity
- Credit score
- Homeowner/renter
- Marital status

Here are several examples:

Share-A-Home (Age and Health) Among my properties, I formerly owned a large 3,200-square-foot, five-bedroom, four-bath single-family house that I rented out for $850 a month to a married couple with children. But in talking with another rental property owner in the neighborhood, I discovered a more profitable use for that house.

It turned out that this investor owned four properties in the area and rented rooms in each of these large houses to individual seniors. Typically, these people were age 70 or older. They were healthy enough to care for their own basic everyday living, but not up to maintaining their own private residence. The investor

Increase rents with target marketing.

essentially operated these properties as high-class boarding houses. He called these houses Share-A-Homes.

Subsequently, I learned that blind luck had favored me. Not only was my property located within a Share-A-Home zoning district, but also, with no changes whatsoever, it met the strict regulatory housing codes that applied to this type of rental property (that is, size of bedrooms, number of bathrooms, number and location of exits, window locks, kitchen facilities, and so on). Although I had no interest in personally running a Share-A-Home, I did lease the house to the operator down the street. My new rent: $1,350 per month.

Share-A-Homes Update: Sunset Village, Inc. After seeing an ad in the *Wall Street Journal* (Figure 5.1), I phoned for more information. When I received the promotional packet, I was amazed to see that the development company soliciting investor funds, Sunset Village, Inc., was building new, upscale Share-A-Homes in a triplex format. Here's an excerpt from the enclosed promotional letter (for the full letter, see Figure 5.2):

> There is no other product in the rental market within our rent range that offers the amenities [fitness center, heated swimming pool, beauty salon, card and super bowl room, putting green, shuffleboard, maid service] that we are offering. Our target market for rental is the senior that cannot quite handle the daily upkeep of a home or apartment, yet they are healthy and are not ready for the assisted living type of care.... Seniors can keep their independence longer.

Sunset Village aims to provide their target markets of investors and residents with a value proposition that's tough to beat. Given the sellout and rent-up rates of their previous Share-A-Home developments, they seem to be succeeding.

30 % RETURN*

NEW 3 Story Triplexes

For Healthy Seniors
Elevators & Health Club
$670,000 10% Dn. ($67,000)

Includes: Mgmt & Financing

1031's OK/Recession Proof

Toll Free: (877) 987-6543

***Projected Rate of Return**

Figure 5.1 Ad for Sunset Village Triplex.

Other Possibilities You can slice and dice demographics in thousands of different combinations. Because you're renting one building at a time, you could pinpoint the needs of a narrow type of person, family, or household. You might tailor rental properties to accommodate roommate living, families with young children, or maybe families with teenage children. Wheelchair-friendly units also seem to be in short supply relative to demand. Some property owners target the financially responsible, yet cash- or credit-impaired renter. One of my previous properties was located two blocks from a hospital. I fixed up the

Different people mean different wants, different needs.

property and drafted a rental agreement that in combination with the improved property appealed to younger, single nurses.

Psychographic Differences

Lifestyle marketing focuses on specific attitudes and values.

Most larger property developers, homebuilders, and apartment complexes combine demographics with psychographics to create their target markets. In this sense, I'm using the term *psychographics* to refer to mental predispositions such as likes, dislikes, tastes, preferences, attitudes, values, and lifestyles. Again quoting from the Sunset Village promotional letter (Figure 5.2):

> . . . Our goal is to offer safe and affordable housing to the healthy, active senior. . . . Many seniors have a major problem with loneliness and the lack of interaction with other people. . . . [Therefore] seniors . . . like this shared living concept . . . and generally form little family-type groups. . . . [W]e are able to sponsor a program of activities for our residents.

Here you can see how Sunset blends demographic characteristics such as old age and reasonably good health with psychographic characteristics such as active lifestyle, social interaction, and safety. Most importantly, you can see how the firm is trying to understand the needs and wants of their target audience, and craft their apartment units, amenities, and services to meet those needs.

Myrtle Beach Condominiums Some years back, I was called in as a marketing research consultant by a developer in Myrtle Beach, South Carolina, who was trying to finance a condominium project. Unfortunately for this developer, his lender thought he was nuts. Why? Because at that time, the national economy was mired in

Dear Dr. Eldred:

Thank you for your interest in Sunset Village.

I am sure that you are aware of the growing number of senior citizens within the State of Florida. Florida is second only to California in senior population and growth and it is a proven fact that seniors are living longer and staying physically healthier.

As a developer of senior housing we have found that there is a great need within the State for affordable senior housing. The information that we have received from the different senior councils and the housing authorities has reinforced our market studies.

We at Sunset Village, Inc. have developed a unique style of rental housing that services the needs of today's seniors. Our goal is to build safe and affordable housing for the healthy, active senior. The two major concerns of seniors and their families are safety and lack of family or social contact. Many seniors have a major problem with loneliness and the lack of interaction with other people. When this happens the seniors have a tendency to fail physically and mentally.

I would like to explain the type of housing that we build. Our developments consist of individual three-story triplexes. Each floor has five bedrooms with individual bathrooms, a shared kitchen and a shared living room. Think of student housing only specialized for today's seniors. These triplexes are fully furnished and the kitchens are fully equipped. Each floor has a laundry room, computer room with a computer and printer and high-speed internet service. In addition to being fully furnished, the bedrooms have a wall safe, ceiling fan, and are key locked for privacy. The living room has a 25" color TV with a VCR. We also offer the Guardian Medical Alert for those who may request that. Our seniors have a homey atmosphere that is very upscale.

We have been advised that seniors, especially single seniors, like this shared living concept; they actually like having the interaction with other seniors and generally form little family-type groups. We try to make each floor coed, and with the help of the local senior organizations and social groups, we are able to have a program of activities in place for our healthy seniors. We have a doctors group that will make house calls, a pharmacy company that delivers prescriptions and gives lectures, home health care and physical therapy on site.

Figure 5.2 Example of Target Marketing.

The Osceola Council on Aging held 15 focus group studies on our shared living product with over 200 participants, and the approval rate was over 75 percent. The focus groups were from very diversified groups of seniors.

The triplexes are joined together by high-speed elevators. The senior developments will have many amenities such as a fitness center, heated swimming pool, beauty salon, card and super bowl room, minibus, putting green, shuffleboard, and professional management on site. After an extensive interview process both in Florida and Atlanta we have chosen Pinnacle Management Group to manage our project in Kissimmee, Florida, Atlanta, Georgia, Pasco County, Florida and they will also manage our newest development, Dolphin Bay Club in Palm Bay, Florida. I have enclosed their resume for your review. The triplexes are furnished by a design group called L.K.L. with ceramic tile and Berber carpet.

There is no other product in the rental market within our rent range that offers the amenities that we are offering. Our target market for rental is the senior that cannot quite handle the daily upkeep of a home or apartment, yet they are healthy and are not ready for the assisted living hospital type of care. With the on-site services that we bring onto the development, seniors can stay longer and keep their independence longer.

Each triplex is rented by the bedroom at the rate of **$675.00 per month for nine bedrooms and $775.00 per month for six bedrooms. Each triplex generates rent on fifteen bedrooms. This rent includes all utilities, phone, satellite cable, and maid service twice per week** (in the kitchen, living room and laundry room), plus all of the amenities on the site. The bedrooms are all pre-wired for satellite cable and telephone service. Our communities are **gated** for the safety of the seniors.

Our project, Shellfish Bay in Kissimmee, Florida, is completely sold out and the first tenants are moving in. Our management team is in the process of leasing these units. We were part of two large senior expos within the last few months and we are happy to say they were very successful. October Mist in Atlanta, Georgia, is sold out, the land has been purchased, and we hope to start construction in approximately six to eight weeks once the construction financing is firmly in place.

Our project in Port Richey, Florida, Windjammer Club, has completely sold out of both Phase I and Phase II. Our construction is in process and we will start pre-leasing in October of this year.

We are now in the process of pre-selling Sunset Village, which is located in Brevard County on the east coast of Florida. We chose this location due to the high amount of senior citizens.

(continued)

Figure 5.2 *(Continued)*

As I mentioned above, **each triplex has fifteen bedrooms, nine bedrooms rent for $675.00 per month and six larger bedrooms rent for $775.00 per month**. The cost of the triplex is $690,000. The way to purchase this investment is as follows: We require a deposit of 10 percent which is paid as follows: $6,000 is to be submitted with the contract, and goes into the development of the project. If you cannot for any reason get your funding, this money is refundable. The balance of $63,000 will be required to be sent to the title company at the time Sunset Village, Inc. is ready to purchase the land and go to construction. Sunset Village, Inc. will pay up to 3 percent of the loan amount in closing costs for you. This will be approximately $18,600.00. We pay this to offset the time that you will be waiting for your triplex to be built.

The net cash flow after all expenses and mortgage payment is approximately $28,000 annually. Enclosed please find a cash flow figure sheet and some general information.

The Adams Group, and Wright Architectural Co. designed our units and we are very proud of the quality of living that our seniors will experience within all of our projects. Forest Park Construction has been our builder for our last two projects and we have complete confidence in their ability to build excellent projects.

Please call me when you receive this packet so that we can go over it together. My toll free number is **(877) 987-6541. I would also like to extend an invitation to you to come to my Orlando office and I would be glad to show you the site and also go over the building plans.**

Per our conversation we deal with three lenders. The name of one is ABC Mortgage Company, the phone # is 800-987-1234 and the contact's name is Wynn Andrews. I will have the other names and numbers available when we speak again.

Sincerely,

Shirley R. Fox
Sales Manager

Figure 5.2 *(Continued)*

deep recession, gasoline prices were shooting up, and, of no small concern, the local Myrtle Beach housing market was littered with unsold see-through, mid-rise, beachfront condo projects.[1]

But this developer wasn't crazy. He had studied his target market well. He knew that as one of the premier golfing centers in the United States, Myrtle Beach attracted hundreds of thousands of visitors each year who cared nothing about the Atlantic Ocean and Grand Strand beaches. These visitors come to play golf all day and eat seafood, drink, and share camaraderie with friends all evening. These golfing buddies didn't need or want an expensive beachfront condo (or hotel). They wanted comfortable, private, and spacious accommodations at an economy price.

Even oversupply doesn't foreclose opportunity.

The developer's value proposition: A 1,350-square-foot townhouse-style, two-bedroom, two-bath condo, situated 14 blocks west of the beach, yet within 10 to 15 minutes of most of the popular golf courses. Because of this off-the-beaten-path location, the developer was able to price the units 60 percent less than the condo price levels that created the beachfront bust. Yet, that wasn't the end of the story.

The developer knew that many golfing buddies circulate within a group of 6 to 10 (or more) friends. To make the condo units more appealing and affordable, he persuaded potential buyers to split the costs of ownership among perhaps 4, 6, or even 10 partners. When marketed in this way, the golfing buddies were able to obtain housing for their chosen weekends that surpassed the quality of anything comparable in the market. And when figured on a per-person, nightly-use basis, the condo cost less than the local Holiday Inn.

Within 18 months, the developer sold out the first two phases of the project and was already planning phase three. In this case, savvy target marketing and product development created huge

[1]A see-through building is a partially built, abandoned project. Because only the skeleton (frame) of the building has been put up, you can see right through it.

profits for this astute entrepreneur—even when most other builders were clinging tightly to their worry beads.

Avoid Standard Labels; Picture Your Actual Renters

Sometimes people refer to broad-based housing segments such as empty nesters, swinging singles, first-time homebuyers, move-up buyers, the age 55+ market, and, more recently, the Hispanic market, the Asian market, and the Islamic market. SRI (formerly known as the Stanford Research Institute, a Menlo Park firm with whom I've done some work) developed a market segment classification system known as VALS (an acronym for values and lifestyles) that was unthinkingly used by builders of many new apartment complexes and single-family homes. Included among these VALS segments are such supposed groups as:

- Survivors
- Belongers
- Sustainers
- Emulators
- Achievers
- Societally conscious

Although any of the above labels might stimulate your thinking, never rely on broad labels to direct your market segmentation strategy. One book for real estate investors tells its readers to sell their renovated properties to first-time homebuyers. But that label (as do all generic segmentation labels) lacks clarity. I learned that fact during the mid to late 1990s when I offered my Stop Renting Now!™ seminars throughout the United States. Surprising to me, seminar attendees fit no specific demographic. They included a range of ages, income, wealth, and family size:

Avoid broad-brush labels.

- Age (25 to 55)
- Income ($20,000 to $120,000)
- Cash down available ($0 to $100,000)
- Credit score (350 to 800)
- Family status (single, divorced, separated, married, married with children, unmarried partners)
- Race (all races)
- Lifestyles (all of the values, attitudes, and life situations that anyone could imagine)

However, these seminar attendees did hold one motivating psychographic preference in common. They wanted to stop renting and start owning. When you create a target market for your properties, think precisely. Picture clearly in every relevant detail the characteristics (demographics, psychographics, lifestyles, preferences, turn-ons, and turn-offs) of the types of people you would like to impress with your PVP. Then fashion the features of your property and leasing program to appeal to those strong motivations.

College Students I've heard many owners of rental houses and apartments declare that they avoid renting to college students. But similar to first-time homebuyers, college students come in all types. My partners and I renovated a 16-unit apartment building specifically for a target market of college students. That building proved quite profitable, and the students appreciated the way we ran the property to serve their needs and wants.

But we didn't just rent to any college students. We targeted top students, nonsmokers, above-average financial resources, mature in demeanor, quiet, and clean. In return, we offered the students one of the most pleasant place to live at a fair rent level. We achieved extraordinary profits through lower costs for repairs, advertising, marketing, and management, as well as virtually zero vacancies and bad debts.

Hitting the Bull's Eye

You might begin your thinking about target marketing with broad-brush labels such as college students, first-time buyers, active seniors, empty nesters, young marrieds, singles, roommates, moderate-income, Section 8s, or even that once ubiquitous segment known as yuppies. And of course, the most popular broad-brush demographic label of all: baby boomers, now followed by Gen Xers, Gen Ys, and echo boomers.

Any of these broad-brush labels might point you toward market segments that share some similar characteristics, but the people within each of these sweeping categories differ. To hit that most profitable bull's eye within your target market, search for the unique and intense needs that motivate specific people.

Find Unique and Intense Needs

To create a highly profitable value proposition, find those intense (motivating) needs and wants that other rental property owners miss. Search for those differences that make *the* difference for the bull's eye segment of tenants that you plan to serve. I found that the nurses I rented to were especially concerned about safety and security; therefore, I increased the amount of outdoor lighting at the property, installed double dead-bolt door locks, and bolted heavy-gauge wire mesh screens on all of the building's first story windows.

Identify your tenants' hot buttons.

In addition, these nurses wanted more closet space than the other older rental units in the neighborhood typically provided. Fortunately, the bedrooms in my older building measured at least 14' × 16'. That feature allowed me to slice off two feet of floor space and add wall-length built-in cabinets, drawers, and closet space in each bedroom. As a special touch, I installed full-length mirrors

on the new closet doors. This not only played to vanity but also enhanced the spacious appearance of the bedrooms.

Bull's Eye Lease Assessment

I rented to the nurses individually, rather than as a preformed group. I also permitted any nurse to get out of her lease at any time if she would find a substitute tenant that proved acceptable to me and the existing residents of the building. These under age 30 women appreciated that flexibility—although few of them exercised this option. In fact, the stability of tenants within the property actually surprised me.

Know your customer.

Throw Away Standard Operating Procedures

Most individual owners of rental properties operate their buildings according to some combination of standard operating procedure, the detailed directions offered by authors of their favorite real estate books, or the owner's personal insights and idiosyncratic prejudices unguided by a customer (tenant) profile. I urge you to practice a more profitable approach. Before you begin your property search, get to know your intended customer. My experiences and the experiences of other entrepreneurs prove that the more closely you identify and attend to the motivating needs of your potential tenants, the more they will reward you with a higher and more dependable stream of rental income.

In contrast to target marketing, owners who offer a generic rental property to a generic tenant earn generic returns at best. If you walk in those shoes, you condemn yourself to so-called market rent levels, for that's what *market* refers to: the average rent for a standard, look-alike product in an open and competitive marketplace. No profit-maximizing entrepreneur will compete with a plain vanilla product.

How Do You Identify the Wow (PVP) Features for Your Tenants?

Because you probably can't read minds, you need some techniques to discover the value proposition that will motivate your bull's-eye tenants to act now. Here are several ideas that have worked for me and other successful investment property owners that I know:

- Talk informally with people; discover their problems.
- Pay attention, eavesdrop, read, watch.
- Talk with insiders and experts.
- Use questionnaires.
- Conduct (informal) focus groups.

Informal Conversations

Perhaps I'm a born inquisitor. No matter where I am, I like to strike up conversations with people to learn their thoughts, problems, likes, and dislikes. In fact, I discovered the housing opportunity for nurses while visiting one of my parents in the hospital. In casual conversation, I asked a nurse where she lived. That opened the door to one of those "Don't get me started on that" comments.

Tenants know what they want. So, ask them.

That backhanded invitation intensified my inquiry and led to further conversation with the nurse. She went on to describe how much difficulty she and her workmates encountered when looking for a decent and affordable place to live near the hospital—which is where they preferred to live given their odd-hour work schedules.

Similarly, because I've spent much of my career teaching at universities, I've often relied on informal conversations with students to learn about their housing problems, preferences, likes, and dislikes. These conversations helped me develop my market strategy for the 16-unit income property mentioned earlier in this chapter, as well as other student apartment rentals that I have owned.

How many people do you know (or know of) who have shopped to buy or rent housing in the past year or two? Talk with them. Learn their reactions to the properties they looked at. Why did they eventually choose their current home? What was the difference that made *the* difference for these people? What features would they have liked, yet found rare or unavailable? Talk with people. Ask questions. You'll surprise yourself at how much valuable information you can pick up.

Pay Attention

Read the neighborhood and communities section of newspapers. Follow human interest stories as well as Q&A columns where people talk about their house hunting and rental problems. Go to your local library and read the articles in the Sunday Real Estate or Homes sections of the *Los Angeles Times,* the *San Diego Union-Tribune,* the *San Francisco Examiner,* the *Chicago Tribune,* the *Orlando Sentinel,* or the Saturday edition of the *Washington Post.* These newspapers not only feature stories on the latest real estate trends but they also carry the nationally syndicated columnists such as Kenneth Harney and Lew Sichelman.

You can also find good idea-provoking articles in magazines such as *CCIM Magazine, American Demographics,* the *Journal of Property Management,* and *Apartment Living.* Eavesdrop. Perk your ears up when people talk about real estate. Visit real estate chat rooms on the Internet. When you discover something new or interesting, mull it over. Ask yourself if this fact, trend, or problem could help you better tailor an investment property toward a bull's-eye segment of renters. What feature or benefit could you offer that strengthens your competitive advantage?

Talk with Insiders and Experts

Every community includes a dozen or more occupations and professions where those employed can gain firsthand insider

information by talking directly with homebuyers and renters. To learn more about your market, talk with any of these people:

- Real estate agents
- Property managers
- Bankers
- Property inspetors
- Credit counselors
- Remodeling contractors
- Real estate investors
- Newspaper reporters who cover housing and real estate
- Existing tenants
- Social service agency personnel
- City planners, building permit inspectors, zoning personnel
- Mortgage brokers
- Professors (architecture, planning, real estate, housing)
- Administrators at the city or state department of housing finance
- Apartment finder services
- Roommate finder services
- HUD section 8 administrators

Ask for advice and insight from professionals who talk with people looking for housing.

Discover demographic and psychographic trends, personal problems, shortages, and surpluses. What features do people want? What services? What amenities? Which locations? Ask who's renting and who's buying where and why. Ask what's hot, what's not. When homeowners remodel, what features do they prefer? Are increasing (decreasing) numbers of people feeling financial pain?

Use Questionnaires

When I was in college promoting rock concerts with national and regional bands (another of my entrepreneurial quests), I needed to learn which bands would likely draw the biggest crowds. Following the principles that I was then learning in my marketing class, I developed a questionnaire and then asked local high school and college students to voice their preferences.

Since that first venture into survey research, I have used questionnaires dozens of times to better understand what tenants and homebuyers want, why they act the way they do, and how they plan to act. Although handing out and collecting surveys may not appeal to you, for $200 or so, you can probably hire a local college student to perform this research for you.

Focus Groups

During the past 20 years, focus groups have emerged as one of the most popular ways to get into the minds of potential tenants and homebuyers. To conduct a focus group, you merely bring together a sampling of people from your proposed target market; then, through give-and-take conversations, you probe into their beliefs and feelings.

Nearly every major home and apartment builder in the country now runs focus groups to learn the thinking of their intended customers. To a certain degree, I ran my Stop Renting Now!(tm) seminars as a quasi-focus group. Real estate firms and mortgage lenders paid my fees. In return, I provided these clients with the names of prospects along with the comments and concerns that I had elicited from seminar Q&A sessions.

In creating its Share-A-Home concept, Sunset Village, Inc., employed the Osceola [County] Council on Aging to hold 15 focus groups (more than 200 total participants). The insights that were gained helped Sunset Village formulate its marketing theme as well as the specific features, amenities, and services that the firm blended into its triplexes and total value proposition.

To take advantage of this research technique, you need not conduct a formal focus group. That probably stretches beyond the time, effort, and money that you want to put into your investment research—at least during your beginning stages. Nevertheless, if you find yourself (or can place yourself) in a group setting, try to get the group to focus on and discuss topics that could alert you

to rental market opportunities. Entrepreneurial investors scout for profitable ideas everywhere.

Anticipate and Adapt to Change

Smart entrepreneurs scout for change. They ask how evolving trends affect the future demand for specific homes, apartments, neighborhoods, and communities.

The Age Wave

Everybody knows that the U.S. population is getting older. During the next 20 years, 60 million Americans will celebrate their 60th birthday. Sixty million new retirees are on the horizon. Where will these people want to live? What kinds of housing units will they want (Share-A-Homes)? What features will press their hot buttons?

As emphasized, though, "over 60" itself doesn't define a target market per se. It flashes the signal to stop, look, and listen. What bull's-eye segments within this over-60 market will remain underserved until some entrepreneur senses their needs and creates a way to fill it? Here are some of the trends that demographers detect.

What features appeal to seniors?

1. *Downsizing.* A shift away from the McMansions that became so popular during the late 1980s and 1990s.
2. *College towns.* Retirees appreciate the combination of education, sports, arts, theater, and diversity without big city costs and aggravation.
3. *Rural/small towns.* Especially those that combine abundant outdoor recreation with a degree of upscale culture (such as Ashland, Oregon).

4. *Single-floor housing units.* Post-60 often prefer to avoid stairs.
5. *Doorways and door levers.* Wider doorways to accommodate wheelchairs and walkers. Door levers are easier to manage than doorknobs.
6. *Mild four-season climate.* Even though Florida will remain the most popular state for retirees, mild four-season states such as Tennessee, Georgia, the Carolinas, and Virginia will become increasingly popular. Also, Mississippi and Alabama will grow their in-migration of retirees.
7. *High-cost to low-cost areas.* Why live in a prewar Brooklyn bungalow when you can rent or own a large, new house or apartment just outside of sunny Orlando or Tampa for less than half the costs in Brooklyn?
8. *Security and low maintenance.* Lock and leave without worry. With extensive travel on the agenda, seniors won't want to concern themselves with what's happening to their home while they're away.

The previously mentioned trends represent just a sample of senior trends. Stay tuned for future developments.

Echo Boomers

Each year, thousands of articles discuss the effects that aging baby boomers will create for the housing market. But to date, the media have not spent much time on another perfectly predictable demographic trend.

The birth years for baby boomers were 1946 to 1964. The birth years for the baby bust were 1965 to 1977. Then, beginning in 1978, U.S. births again started to climb into the 4 million a year range, and continued at or near that pace for more than 15 years.

The first of these so-called echo boomers turned 25 in 2003. Reminiscent of the 1970s, near record numbers of people 35 or under will populate the entry-level housing market. What types

Near record numbers of young people will enter the rental market.

of apartments, what features, what locations will appeal to the diverse segments of the echo boomer generation? Put up your early detection antennae.

Local Trends and Changes

The age wave of the baby boomers and the echo boomers represents two definite and profound demographic changes that will hit full stride during the coming years. Most importantly, how will these trends impact the areas where you plan to invest? Or vice-versa—can you discover areas (neighborhoods, communities) that stand to benefit from the exploding growth of these two age groups?

What other demographic and psychographic trends are occurring in your investment area? When you talk with local housing experts and insiders, envision the future. Explore views about population and community changes. Track shifts in tastes, age distribution, incomes, job growth, and neighborhood popularity. As they say in hockey, don't skate to where the puck is now; skate to where it's headed.

Find a trend and ride it to profits.

Plan to play into a trend. As the trend grows, so does your knowledge and ability. You learn from your tenants. You refine and expand your property purchase, property improvement, and rental strategy. Your profits grow as the trend continues to roll along.

CHAPTER 6

Is the Property a Good Deal?

Investors who seek superior returns value properties according to multiple criteria. To make great deals, think through what the property will do for you, as well as what you can do for the property. To begin, calculate the following benchmarks:

- Replacement cost
- Per unit measures
- Gross rent multipliers
- Capitalized value
- Growth in equity
- Potential for creating value

Apply these criteria and you'll see that even a below-market price may not yield the rate of return and margin of safety you would like. And contrary to popular belief, at times you can achieve a great return plus a margin of safety, even if you pay above-market value (though, of course, you try to negotiate the best price and terms, regardless of the extra value that you see in the property).

The trick, of course, is to know what you're doing and why you're doing it. Some investors jump at below-market buys and reject in knee-jerk fashion properties firmly priced above market. On closer inspection, either of these decision strategies may err.

How Much Would It Cost to Construct the Property Today?

Over time, higher building costs pull up property values.

Investors like to profit as their properties appreciate. Over time, as construction costs go up and population grows, that's a safe forecast. In the short run, though, current market values sometimes jump too far above building costs. Eyeing large profits, builders rush to construct new houses, condominiums, and apartments. The market becomes glutted and then property prices and rents falter.

The Construction Cycle

To recap our previous discussion, here's how the construction cycle works. Typically, a city, town, or vacation area begins to boom. Jobs and wages go up. More people move in. Interest rates decline. Apartment rents and home prices start to take off. Vacancies disappear. Inventories of unsold homes decline. Pretty soon, *existing* homes or apartments that could be built *new* for, say, $100,000 per unit begin to command values of, say, $120,000, $130,000, or more.

Builders Spy Opportunity With market values of existing properties well above replacement costs, builders can quickly make a lot of money. Build at $100,000, sell at $130,000. Great! $30,000 profit. Unfortunately, too many builders frequently rush to meet the growing demand. Due to exaggerated expectations, supply multiplies. A shortage becomes a surplus. Buyers who bought near the top of the cycle face disappointment (or worse) as rent levels and values temporarily stagnate or slide back to lower levels.

Recovery Builders pull back, and gradually excess inventories get sold or rented. Vacancies tighten; inventory falls. Potential renters again outnumber the supply of available properties. Property

values and rents stabilize at first, but then edge up. Eventually, as shortages appear, vacancies dwindle. Prices take off on another rapid run. The construction cycle turns another revolution.

Implications for Investors

Prior to recent downturns, the last boom-bust cycle occurred in Texas in the mid- to late 1980s. Properties that could be built for $75,000 to $100,000 sold for as much as $125,000 to $150,000. Condos and apartment projects multiplied with reckless abandon. Large real estate tax-shelter benefits added fuel to the fire. Just as with today's Miami and Las Vegas, rapid price increases fed on themselves—until the music stopped.

Large profits for builders can bring too much new supply to the market.

The moral: Stay in touch with local builders or others who are in the know about contractor costs (building suppliers, lumber yards, appraisers, construction lenders). Or you might turn to one or more construction cost services. You can easily follow your local building costs through their manuals (at your library) or their web sites. When builder profit margins grow ever fatter, oversupply will surely result.

Profit When Values Drop below Costs Rents low? Vacancies climbing? Unsold houses and condos piling up in the Realtors' Multiple Listing Service? Builders going bankrupt? Lenders foreclosing? Great! That's the perfect time for investors to buy—especially when market values end up below replacement costs because that means few builders will venture forth. Why pay more to build than you can get from a sale?

As long as emerging trends in the area point to a larger population, more jobs, a growing economic base, and a sought-after quality of life, prices (rents) are guaranteed to rise. More demand pressing against a relatively fixed total supply will reward investors with handsome returns.

Clean-Up Crews Earn Good Money We frequently hear about the boom-bust cycles of real estate. But, in fact, the notorious (1980s to 1990s) boom-busts of Texas, California, New York City, and several other areas do not reflect the norm. Property markets in most areas remain far more stable. The odds are that you will never experience that kind of shakeout. While perhaps that's good in one sense, it's bad in another because clean-up crews can make stupendous returns. Consider the Reichmans, who marched into New York City during its 1974-1977 recession. Within a relatively few years their $300 million of office building acquisitions (primarily with borrowed money) carried a value in excess of $1 billion.

At the other end of the spectrum, a former student of mine in Dallas—whom I had taught at Southern Methodist University—bought his first investment during the down cycle of the early 1990s: a small foreclosed house for $8,000. After spending $2,500 for repairs and refurbishing (most of which he performed himself), he leased the house for $350 a month.

In buying during such hard times, did the Reichmans or my former student take a big risk? Quite the contrary! The purchase prices of their properties lay so far below replacement costs that they were taking virtually no risk of any consequence. Both Dallas and New York City were (and remain) major capitals of industry and financial services. With their long-term growing base of jobs and population, a huge recovery in prices was only a matter of when, not if. In the meantime, the existing rents from the properties provided high cash flows.

Surplus markets reduce risk.

As local or regional shakeouts recur, stay informed. Follow large upswings in the number of foreclosures. Today's downturn fueled by loose lending and overbuilding has created many opportunities to buy below replacement cost; grab that opportunity. Adopt the motto "Have Money (Credit), Will Travel." If the bargains don't come to you, go to the bargains.

Have Money, Will Travel

Local (Regional) Recessions

Even without overbuilding, property prices can sometimes fall below replacement costs due to job declines and/or a recession. During the early 1990s, large layoffs in defense and aerospace firms created the housing troubles of Southern California. Recall the economic job base issues from Chapter 3. Overbuilding and/or job losses can offer great opportunities to buy during a down cycle.

Market value < Replacement cost = Bargain hunter's delight

Per Unit Measures

Real estate investors rely on various per unit measures to decide whether a property looks like a good buy. As with all gross or rule-of-thumb measures, *per unit figures* signal whether a property tends to be priced over or under some benchmark norm. While not compelling on their own, these measures do provide meaningful benchmarks for investor comparisons.

Quickly calculate per unit price comparisons.

Per Apartment Unit

When looking at multi-unit apartment buildings, divide the asking price by the number of apartment units in the property. For an 8-unit property priced at $450,000, you would calculate:

$$\text{Price per unit} = \frac{\$450{,}000}{8}$$

$$\text{Price per unit} = \$56{,}250$$

If you know that other similar apartment buildings have typically sold for $60,000 to $70,000 per unit, you may have found a bargain. In addition, this and other *per* measures give you a quick way to compare prevailing prices when buildings differ in unit sizes. Say you compare 6-unit, 9-unit, and 11-unit properties at the respective prices of $275,000, $435,000, and $487,500. Figure per unit prices, and you can more easily rank the properties from lowest to highest priced.

No. Units	Price	Price per Unit
11	$487,500	$44,318
9	$435,000	$48,333
6	$275,000	$45,833

Size, Quality and Location Ideally, the units you compare will closely match each other. If that's not possible, adjust your valuations to reflect size, quality, and location differences among properties. Try to spot those "differences that make a difference." You can better judge properties according to their relative desirability and profit potential.

Buy in one market. Sell in another.

Opportunity Knocks (Arbitrage) Though price-per-unit measures help you find bargain buildings, this measure also spotlights opportunities in two other ways:

1. *Size.* Change the size of the units from larger to smaller, or vice versa. Imagine that smaller 700- to 800-square-foot units sell and rent at substantial premiums over larger 1,200- to 1,400-square-foot units. Thus, buying a building of predominantly larger units could pay off big when you reconfigure the building into one composed of smaller-sized units.
2. *Conversion.* You might also profit by noticing that buildings with two-bedroom rentals typically sell in the $40,000 to $50,000 per unit range. In contrast, in similar

condo buildings, two-bedroom units sell in the $70,000 to $80,000 range. Or, the price disparity could work in the opposite direction. Either way, you may be able to buy at the lower-priced use, convert, then sell (or rent) at the higher-priced use.

Although the previous types of arbitrage do not occur often, they do arise every now and then. So, compare relative prices. Stay poised to jump when this arbitrage opportunity knocks.

Per-Square-Foot Measures

Property buyers and sellers refer to a house or other type of property by noting that it sold for, say, $335 per square foot. Price per square foot (p.s.f.) represents one of the most widely used methods of benchmark pricing. Investors and homebuyers alike rely on it to provide a ballpark measure of relative value. To calculate a per-square-foot figure, simply divide the square footage of the property (house, apartment, or building) into its price.

$$\text{p.s.f.} = \frac{\text{asking price}}{\text{square footage}}$$

$$\text{p.s.f.} = \frac{\$285{,}000}{1{,}900}$$

$$\text{p.s.f.} = \$150$$

If comparable (comp) sale properties typically have sold at $170 to $180 p.s.f., you may have found a bargain at a price of $150 p.s.f.

Caveats Simple math, but the numbers can mislead. As pointed out in Chapter 2, homebuyers and investors both go wrong using p.s.f. figures because no consistent standards apply to square foot measures. All square feet are not created equally in terms of quality, design, rentability, and usability. Interpret p.s.f. cautiously.

Ill-designed and poorly constructed buildings are worth far less per square foot than functionally and aesthetically superior properties. Also, watch out for mismatches of size. Some buildings display room counts or room sizes far out of proportion to each other, or to competing properties.

Not all square footage counts equally.

Use p.s.f. measures as a guide, but don't pay top market prices for low-quality, ill-designed, ill-usable space. When I first began to buy apartments that had been converted from large houses, I failed to appreciate this point. Keep your critical senses tuned. Evaluate quality as well as quantity.

Land Value Caveat Per-square-foot pricing for existing properties represents gross value figures. It includes the value of the building, the site improvements (fences, parking, decks, sidewalks, driveway), and the lot (land). As a rule-of-thumb benchmark, the technique works well—except when your comparable properties sit on sites that differ greatly in value.

Value land separately from the building.

For example, say you're checking p.s.f. prices and find a four-unit building that recently sold for around $450,000, or $89 per square foot. You find a similar four-unit property five blocks away. It's priced at a p.s.f. of $70. Have you found a bargain? Apparently so—until you learn that the lower-priced property sits within the boundaries of a higher crime area. As a result, its site is worth $50,000 less than the lot of the other quad that recently sold. Of course, relative to its rent levels and appreciation potential, this $70 p.s.f. quad still might make a good buy, but the p.s.f. price alone wouldn't tell you that. The lesson: Don't read too much, too soon into per-square-foot price comparisons. Verify comparability of the property and the location.

Replacement Costs When costing new construction (see preceding section), builders often quote costs as price per square foot.

Caveats apply here, too. Unlike comp sale p.s.f. figures, builder p.s.f. costs often exclude the value of the lot. Also, cost estimates can range all over the field. They differ among builders, and they differ by types of materials, the quality of the finishing, and the brands of the appliances.

Before you apply a price-per-square-foot construction cost figure to a property you value, understand the estimate. In my area, the construction costs for newly built apartments range from a low of $60 p.s.f. up to more than $100 p.s.f. Match like to like.

Price Per Front Foot

Popular as a pricing metric for retail sites, price per front foot plays a relatively small role in valuing residential properties. Homebuyers or residential investors use front footage to benchmark waterfront sites. Because the most popular benefits of owning lakefront are views and beach area, the larger a site's shoreline, the greater its desirability, and the higher its value.

If waterfront is valued at $4,000 per front foot, a one-acre site with 125 feet of shoreline would sell at $500,000. If a site included only 80 feet of shoreline (other things equal), its value would equal $320,000. Of course, it's when other things are *not* equal that throws value estimates off. But as a rule of thumb, price per front foot *can* prove useful.

Gross Rent Multipliers

To value apartment buildings, investors frequently use annual or monthly gross rent multipliers (GRMs). An investor might check several comp sales and discover the following data:

Annual	Gross Rent	Sales Price	Annual GRM
College Terrace	$55,000	$434,500	7.9
Bivens Lake Apts.	$62,700	$526,680	8.4
Four Palms	$48,300	$323,610	6.7

If you find an income property with a relatively high GRM, it could signal either a price too high or rents too low. Further checking would reveal the answer. Throughout the United States and Canada, GRMs run as low as 4.0 (such as rundown properties or unpopular neighborhoods), and as high as 18 (coastal California cities). In my present university-dominated town, gross rent multipliers typically range from a low of 8.0 (unexceptional student housing) to 12 (newer units in professional, but not premier, neighborhoods).

High GRMs signal negative cash flow.

When annual gross rent multipliers go much above 8.0, you find negative cash flows—unless you increase your down payment to 30 percent or more.[1] Because urban and vacation towns with high housing prices often produce GRMs of 10 or higher, income-oriented investors who live in those areas should buy their apartment buildings elsewhere. Or, income-oriented investors in high-priced areas can look for neighborhoods or market niches (lower-middle segment, outlying suburbs) that offer a better price to rent relationship.

Capitalized Value

For income properties of all types (retail, office buildings, apartment complexes), investors rely heavily on the following formula:

[1]Based on current mortgage rates for creditworthy investors of around 6.5 to 7.5 percent on small income properties.

$$V = \frac{NOI}{R}$$

Where V represents the estimated market value of the property; NOI (net operating income) represents the property's rents less expenses; and R equals the market capitalization rate. This formula is the real estate investor's version of the price/earnings (P/E) ratio that is used by stock market investors. Here's how this technique would look for a six-unit apartment building:

	Income Statement (Annual)	
1.	Gross annual potential rents ($725 × 6 × 12)	$52,200
2.	Income from parking and storage areas	5,062
3.	Vacancy and collection losses @ 7%	(4,009)
4.	Effective gross income	$53,254
	Less operating and fixed expenses	
5.	Trash pick-up	$1,080
6.	Utilities	450
7.	Licenses and permit fees	206
8.	Advertising and promotion	900
9.	Management fees @ 6%	3,195
10.	Maintenance and repairs	3,000
11.	Yard care	488
12.	Miscellaneous	2,250
13.	Property taxes	3,202
14.	Property and liability insurance	1,267
15.	Reserves for replacement	1,875
	Total operating and fixed expenses	$17,914
16.	Net operating income (NOI)	$35,340

Calculating NOI looks straightforward. If you're not careful, though, you might err in several ways. To alert you to possible traps, think about the following caveats and explanations (which

match up numerically with the entries shown on the income statement).

1. *Gross annual potential rents.* For this figure, use the property's existing rent levels; if its current rents sit above market, use market rent levels. Verify all leases for rental amounts and lease terms. Do not use a rent figure based on your anticipated rent increases (if any).
2. *Extra income.* With many properties you can charge for rental application fees, parking, storage, laundry, party room, garages, and so on. Verify all such existing income. Don't project extra income that's not been proven by past operating experience or reasonable market data.
3. *Vacancy and collection losses.* Use market vacancy rates, or the current owner's vacancies for the past year, whichever is higher. Also, when judging market vacancy rates, take your figures from the market niche in which this property currently operates. Vacancy rates may vary significantly by location, apartment size, quality, and rent level. As you compare vacancy rates by market niche, try to spot those segments that are experiencing the greatest shortages.
4. *Effective gross income.* From this cash, you pay property expenses and mortgage payments. If you overestimate rent levels or underestimate vacancies, you may end up short of cash.
5. *Trash pickup.* Verify rates and permissible quantities. Look for lower-cost alternatives.
6. *Utilities.* In addition to common area lighting, some buildings include centralized heat and air systems. Verify the amounts of these expenses with utility companies. (Personal note: I would never again operate a building where apartment units lacked individual HVAC units—unless the building price was extremely low or the HVAC system extremely efficient. Most older centralized

systems seldom distribute heat and air conditioning uniformly. Tenants persistently complain about being too cold or too hot.)

7. *Licenses and permit fees.* On occasion, owners of rental properties are required to pay municipal fees of one sort or another.
8. *Lease-up expenses.* Ideally, you will generate a good supply of rental applicants from free postings, referrals, and inquiries; otherwise, you may need to advertise. Also, you'll probably need to pay for credit checks on potential tenants.
9. *Management fees.* Even if you self-manage your units, allocate some expense here for your time and effort. Don't confuse return on labor for return on investment.
10. *Maintenance and repairs.* Ditto. Enter an expense to pay yourself or others. "I'll take care of that myself" shouldn't mean "I'll work for free."
11. *Grounds maintenance.* Maintenance of the grounds entails mowing the lawn, trimming hedges, removing snow, cleaning up leaves, tending to the flower beds, and so on.
12. *Miscellaneous.* You will incur expenses such as lease preparation, auto mileage, and long-distance telephone charges.
13. *Property taxes.* Verify amount, tax rate, and assessed value. Check accuracy. Note whether the property is subject to any special assessments (sewer, sidewalks, water reclamation).
14. *Property and liability insurance.* Verify exact coverage for property and types of losses. Increase deductibles for property damage and maintain at least $2 million limits on liability coverages.
15. *Reserves for replacement.* Eventually, you'll need to replace the roof, HVAC, appliances, carpeting, and other limited-life items. Allocate a pro rata annual amount here.

16. *Net operating income (NOI).* Subtract all expenses from effective gross income. You now have the numerator (NOI figure) for

$$V = \frac{NOI}{R}$$

Investors first conservatively figure a building's NOI. No grand assumptions about potential rent increases. They don't omit necessary expenses. They try to verify and double-check all expense figures. They charge for their own labor (if any), and they allocate reasonable amounts for replacement reserves. In addition, ask to see the sellers' Schedule E where they have reported property revenues and expenses to the IRS. (You may get resistance on this request, so carefully weigh the sellers' response.)

Ask for the sellers' Schedule E.

Estimate Market Value

To calculate value, next come up with an appropriate capitalization rate (R). This rate represents your unleveraged, pretax annual cash return, just as the dividend yield represents an unleveraged, annual cash return on stocks. The cap rate (R) for income properties typically towers over the dividend yield for stocks.

Calculate R To calculate a cap rate, compare the NOIs (net operating incomes) of similar properties with their respective selling prices. To come up with this type of information, talk with competent realty agents who regularly sell (and preferably own) commercial/multifamily properties, other investors (from a local real estate investment club, for example), property management firms that handle sales, and property owners who have recently sold. People in real estate (generally) tend to help each other and share information.

Cap rates are set by local markets.

Property	Recent Sales Price	NOI	R, %
Hampton Apts. (8 units)	$452,900	$43,211	9.54
Woodruff Apts. (6 units)	360,000	35,900	9.97
Adams Manor (6 units)	295,000	28,440	9.6
Newport Apts. (9 units)	549,000	53,170	9.78
Ridge Terrace (8 units)	471,210	42,409	9.0

From the various comparable property cap rates (R), you would select those buildings and locations most comparable to the property you're evaluating, say 9.0 to 9.5 percent. You would then calculate a market value range for the property you're appraising as follows:

1. $$V = \frac{\$35{,}340\ (NOI)}{.09\ (R)}$$
   $$V = \$392.666$$
2. $$V = \frac{\$35{,}340\ (NOI)}{.098\ (R)}$$
   $$V = \$360.612$$

The lower the cap rate, the higher the value.

Throughout the United States, cap rates for rental properties may range from less than 4 percent up to 12 percent, 14 percent, or higher. Generally, a *low* cap rate occurs when you value highly desirable properties in good to top neighborhoods. Relatively high cap rates tend to follow less desirable properties in so-so neighborhoods. Apartment buildings with condo conversion potential tend to sell with low cap rates. (Remember, a low cap rate translates into a relatively high value, and a high cap rate produces a relatively low value.)

If you find that across all types of properties and neighborhoods in your city, cap rates in your area are too low (i.e., prices are too high), search other areas. High cap rates (lower earnings multiples) may offer lower risk and higher cash-on-cash returns.

P/E Ratio Analogy Stock market investors may see the parallel between cap rates and P/E ratios. If a property sells with a cap rate of .085 (8.5 percent), that figure would represent a P/E multiple of close to 12. Conversely, a stock with a P/E multiple of, say, 14 would show an earnings yield (cap rate) of 7.1 percent (.071). Either way, these similar techniques both try to show the relative valuation of a stream of income. With stocks, a stream of corporate earnings—with real estate, a stream of rental earnings.

Likewise, over time these yields will move up or down according to the strength of the economy, the outlook for interest rates, the potential for higher rents, the quality of the income, and various risk factors. No single cap rate can ever represent the "correct" rate. You must investigate each property submarket.

Anticipate the Future; Pay for the Present

In the previous example, you would rely on *verified* income and expense figures drawn from the property's current operating history and your knowledge of competitive properties. Yet, as an entrepreneurial investor, you will make changes to the property through improvements, better management, and perhaps even neighborhood revitalization. These three changes can boost net income and at the same time lower the property's cap rate. Your property's value can quickly jump by 20 percent, 30 percent, or more.

Sellers will ask you to pay for potential. Investors pay for the present.

So, exercise caution. When you negotiate to buy, focus on the present, not your (or the seller's) vision of the future. Investors who anticipate great profits often pay too much. They let the sellers capture the value potential that they plan to create.

Reason and Judgment When you buy conservatively, you widen your margin of safety. Yet, you may run across a super property

at a relatively high price. Should you automatically reject it? Not necessarily. But before you buy, check, verify, and recheck your optimistic expectations. Sometimes a "fully valued" property with extraordinary potential will outperform a bargain-priced property with very limited upside.

When you buy high, know the risks. Unnoticed perils have brought down many a sure thing. Does your market data on the local economy, your target tenants, and competing properties (rents, features) truly support your plans to grow the property's NOI?

Avoid signaling your plans to a seller.

Mum's the Word Novice investors, especially, tend to give away too much of their plans for a property. To buy at a conservative price, don't show your cards to the sellers (or their sales agent). When you question the sellers in ways that reveal your value-creating ideas, the sellers will likely use that potential to strengthen their own negotiating. Sellers already hold inflated ideas about all the great things you can do to enhance their property—which regrettably, they say, they never had the time (or money) to accomplish. Because such ploys are common, you need not load the sellers with even more ammunition to fire back at you. As much as possible, negotiate from the present. Capture the future as reward for your entrepreneurial insights.

Cash-on-Cash Return

Many investors judge properties by the cash-on-cash rate of return they can achieve. As a result, investors scrutinize the cost and terms of their financing as much as they do a property. To illustrate, let's bring forward that six-unit apartment building from several pages back. Assume you can buy that property for $350,000, or just under $60,000 per unit. You talk to a lender

and tentatively arrange a mortgage for $280,000 (an 80 percent loan-to-value ratio). The lender wants an 8 percent interest rate with a 25-year term. You would need to come up with $70,000. Here are the figures:

Loan amount	$350,000
Annualized mortgage payments @ 8.0%; 25 years	25,932
Net operating income (NOI)	35,340
Less mortgage payments	25,932
BTCE (before tax cash flow)	9,408

$$\text{Cash-on-cash return} = \frac{\text{BTCF}}{\text{Down payment}}$$

$$= \frac{\$9{,}408}{70{,}000}$$

$$= 13.44\%$$

Not bad. But say your hurdle rate equals 15 percent. What might you do to boost your cash-on-cash return? Ask the lender to extend the loan term to 30 years. If successful, your annualized payments (assuming no change in interest rate) would drop to $24,652; therefore, BTCF would increase to $10,688 ($35,340 — $24,652):

$$\text{Cash-on-cash return} = \frac{\$10{,}688}{70{,}000}$$

$$= 15.3\%$$

If you don't like a loan term of 30 years, push the lender down to a 7.625 percent interest rate. In that case, your annual mortgage payments (25 years) would total $25,102. Your BTCF would equal $10,237 ($35,340 — $25,102):

$$\text{Cash-on-cash return} = \frac{\$10{,}237}{70{,}000}$$

$$= 14.28\%$$

That lower rate won't quite do it. But, you can try other options:

1. Push for an even lower interest rate (7.5 percent would work).
2. Ask the seller to take back an interest-only balloon note for five years at 7.0 percent for, say, $20,000.
3. Negotiate a lower price for the property.
4. Switch from a 25-year, fixed-rate mortgage to a 7.0 percent 5/20 adjustable-rate mortgage. This tactic would work well if you planned to sell (or exchange) the property within five years.
5. Look for ways to boost the property's net income. Increase rent collections. Raise occupancy. Cut expenses. (See the following chapters for several dozen ideas.)
6. Agree to pay the seller a higher price in exchange for owner financing on terms more favorable (lower interest rate, lower down payment) than a bank would offer.

You find a property. You negotiate and structure a good deal.

Any or all of these techniques *could* work. Experiment with the numbers and negotiate for some agreeable solution. In real estate, the "market" never provides you a return. You provide your own return based on the price, terms of financing, property improvements, management, and market strategy that you put together.

Growth in Equity

Your real estate wealth will grow through property appreciation and mortgage amortization (paying back the amount you borrow with the rents you collect). Together, appreciation and amortization turn acorns (small down payments) into oak trees (equity that multiplies 5, 10, 20 times, or more). To see this wealth-building power of income properties, look at Figure 6.1.

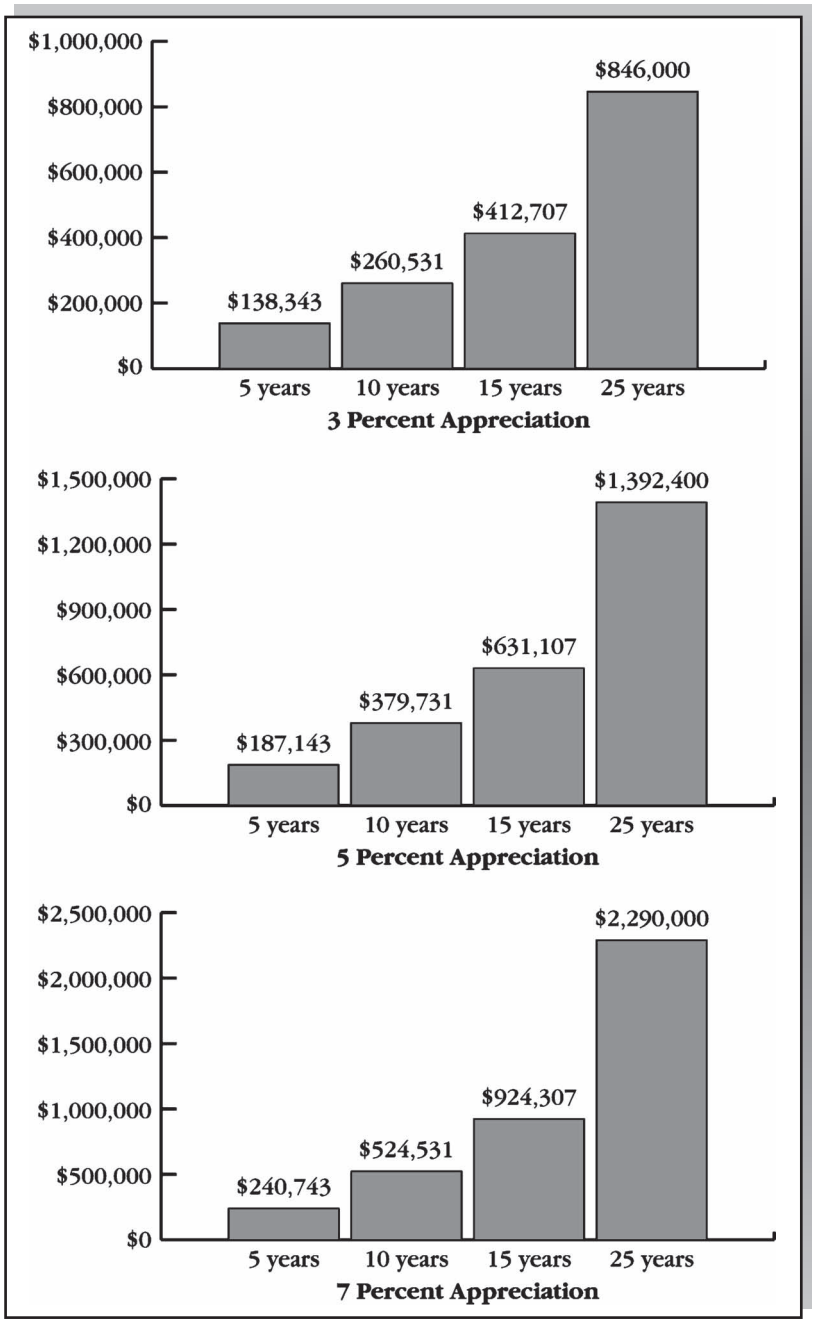

Figure 6.1 Equity Growth: Acorns into Oak Trees.

Say you buy a $400,000 fourplex and finance it with a 90 percent loan at 6.5 percent interest for 25 years. You think this property will appreciate at least 3 percent a year, but it could increase in value by as much as 7 percent a year. Under this range of assumptions, after five years, your original equity of $40,000 grows to at least $138,343. And at the higher appreciation rate of 7 percent, your equity after five years would hit $240,743.

Think about these numbers. You easily see that when invested in property, money grows 5, 10, 20 times over even without grandiose assumptions about the rate of appreciation. These figures reveal the power of leverage.

Now, compare these figures to stocks. Assume that instead of buying this property, you bought $40,000 in stocks and earned a 10 percent rate of return. Here's how your $40,000 would grow:

Stock Returns at 10 Percent

Today	5 Years	10 Years	15 Years	25 Years
$40,000	$56,000	$108,280	$178,120	$482,240

When you place these alternative investments side by side, you see that property wealth wins by a long shot. (And we haven't even counted the growing cash flows you'll receive as rent collections increase over the years.)

Don't Settle for Low Rates of Appreciation

Create your own appreciation.

As an entrepreneurial investor, you need not settle for property appreciation rates of 3, 5, or even 7 percent. Unlike stocks, use your entrepreneurial skills to study the market, improve the property, develop a competitive edge for your target market, and locate communities and neighborhoods that are poised to beat the market. Any of these efforts accelerate your gains in equity. With that goal in mind, we turn to the next several chapters.

CHAPTER 7

Collect More Rents

Recall the value formula discussed in Chapter 6:

$$V = \frac{\text{NOI (Net Operating Income)}}{\text{R (Capitalization Rate)}}$$

You boost the value of your property when you increase NOI or decrease R. To illustrate: Assume that you find a 10-unit property that earns an NOI of $48,000 a year. Based on talks with real estate agents, investors, and several appraisers, you figure this property should sell as is with a cap rate of 9 percent (.09). Accordingly, you calculate the as is value of these 10 units at $533,333.

$$533{,}333\ V = \frac{48{,}000\ \text{(NOI)}}{.09\ \text{(R)}}$$

If you negotiate with a motivated seller (rather than an owner who's just testing the market), you could probably buy this property for around $525,000, give or take, depending on terms and conditions. If you did nothing but maintain occupancy and property conditions, you could expect a 3 to 6 percent a year rate of appreciation.

Become a value creator.

Never Accept Average

If such average appreciation rates satisfy your wealth-building goals, sit back, hire a caretaker apartment manager, and collect your rent checks without serious thought, work, or worry. But you need not accept average. To get on the fast track for building wealth, study the market and put on your entrepreneurial thinking hat. Make changes that boost the property's NOI by just 10 percent and drop your R to 8.5 percent, and you jump the value of this property to $621,176—an immediate gain in equity of $87,843 ($621,176 less $533,333):

$$\$621{,}176 = \frac{\$52{,}800 \text{ (new NOI)}}{.085 \text{ (new R)}}$$

Are such large increases in value possible within, say, a period of 6 to 12 months? Absolutely! Why? Because most owners of small income properties run their operations as landlords, and they treat their residents as mere renters (vassals) with the demeaning connotation that word often implies.

In addition, most investors do not intelligently survey competing properties, nor do they persistently adapt their market strategies to resident needs, wants, and preferences. To speak of a PVP (preferred value proposition) or target marketing to these owners would get you a "What the heck are you talking about" look. Luckily for you, most owners of smaller retail, office, and multifamily properties do think they live in feudal times.

Stand Out and Stand Above

Never become a landlord.

Never think of yourself as a landlord. Never define what you do as "owning income properties." Instead, think of yourself as providing your customers (lessees) with a property that stands above your competitors. If you adopt this attitude, your profits will climb far above average for two reasons:

1. *Better tenant relations.* The tenants of your properties will reward you with lower turnover, higher rents, and fewer problems.
2. *Alert to opportunities.* With a customer-oriented, constant-improvement attitude, you will consistently come up with ideas that add value to your property operations.

A Strategy of Your Own

Good management and marketing depend on continued study of competing properties and customer preferences. No one can tell you the specific strategy that always yields the highest profits. Certainly, you can read a dozen (or more) books on how to be a landlord, and most of them will give you a precise list of do's and don'ts that cover everything from rental applications to waterbeds. Even though ideas from such books often prove helpful, never accept them as the final word.

What works today may not work tomorrow. What works in Peoria may not go over in Paducah. What works in a tight rental market may prove less effective in a high-vacancy market. What works best with HUD Section 8 tenants may actually turn away those upscale residents of your more expensive buildings. Should you accept pets, smokers, or college students? It all depends.

In principle, always offer your selected segment of renters the value proposition that they prefer, yet, at the same time, make sure it's a value proposition that grows your bottom line. In practice, though, you can find that profit-maximizing value proposition only through market study and experimentation.

In this and the following chapters, you will see how to beef up your NOI and lower the cap rate that future buyers (other investors) will apply to your properties. But in keeping with the overall theme, recognize that no one can know precisely what will work best:

- For you
- In your market

- For the types of properties you will own
- For the types of tenants that you would like to attract
- With respect to your personal resources (time, money, effort, imagination)

Experiment to improve.

Nevertheless, develop an alert attitude, an open mind, and a desire to learn, and you won't merely build wealth with income properties but you will do so at a quick pace.

Verify Current Rent Collections

When you begin to shop for income properties, accurately assess the as is value of the property; otherwise, you risk overpaying. But that task isn't really as easy as Chapter 6 implies. In fact, your need for intelligent analysis is heightened in the field of income properties (relative to single-family houses) not only because each multifamily/commercial property stands unique to all others but also because owners and their sales agents rarely tell you everything they know about their properties. If you expect full and accurate disclosure, you're fantasizing.

Truth, lies, and income statements.

As a matter of law and practice, sellers and their agents in this market are held to lower standards of truthfulness. Before individual investors (buyers) can claim in court that they've been duped by a seller's misrepresentations or nondisclosures, such buyers generally must show that they complied with their legal "duty to investigate."

In fact, nearly all property income statements, flyers, and sales brochures include a disclaimer such as the following:

> The information herein has been obtained from sources believed reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty,

> or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions, or estimates used are for example only and do not represent the current or future performance of the property. The value of this transaction to you depends on tax and other factors which your tax, financial, and legal advisors should critically review and evaluate. You and your advisors should conduct a careful, independent investigation of the property to determine to your satisfaction the suitability of the property for your needs.

Essentially, this disclaimer says that "You are on your own." No matter what the sellers or their sales agent tell you about a property's past (or future) rent collections (and expenses), you still must conduct your own "careful, independent investigation." To confirm (or question) an owner's reported rent collections, apply the following techniques.

Examine All Leases and Rental Applications

Review the leases. Learn the names of all current residents, the rental rates for each unit, the lease expiration dates, the amounts of deposits, whether the owner provided rent concessions, and any supplementary payments for, say, pets, parking, or extra tenants. From the lease applications (if the seller will show them to you), you can try to determine the creditworthiness of the tenants, their places of employment, and the period of time each tenant has lived in the building.

Verify the rent roll.

Interpreting the Rental Information

Such tenant information will provide in-depth (and perhaps a more accurate) view of both the quality and quantity of rental revenues.

For example, you could find that a high percentage of tenants have moved into the building only recently; they posted small security deposits; they tend to work in unstable jobs; and they suffer credit scores that scrape bottom. Obviously, a tenant mix of this caliber will typically result in high turnover, collection losses, and, perhaps, more damages to the property. Almost certainly, these tenants will not provide the amount of rent collections or net operating income that the owner claims. Discount accordingly.

On the other hand, you might find a building with a resident mix of strongly qualified long-term tenants who have posted large security deposits as well as deposits for their last month's rents. In addition, the owners of this property show you a bona fide waiting list. In this case, not only does the owners' reported rent collections seem reliable, but you may have found a building that would experience low vacancies even at higher rent levels.

Rent Collections, Not Rental Rates

Too many new investors accept the owner's rent figures and then allow for a 5 percent vacancy factor. In truth, many property owners do not *collect* 95 percent of their scheduled rents—even if they achieve 95 percent occupancy. So, Step 1, verify rents, verify the lease rates the tenants have agreed to pay. Step 2 realistically estimate vacancy and collection losses. Your profits, and the building's value, rest upon bankable funds, not leaky leases.

It's not how much you charge; it's how much you collect.

Talk with Tenants

Before you buy an investment property, talk with a sampling of the building's tenants. This practice serves four purposes.

1. Identifies problems in the building.
2. Identifies problems with tenants.

3. Verifies lease and application data.
4. Generates ideas for improvement.

Problems in the Building "Not enough parking." "Too much noise." "The bills for heat and air are outrageous—$277 last month." "These walls are paper thin." "This place lacks security. We've had three break-ins during the past six months." "The closets in this apartment are too small, and there's no place for long-term storage." "No place to park or store my bicycle." "Cockroaches, ugh. This place is crawling with cockroaches."

To really learn about a building, talk with the tenants. This question nearly always elicits a response, "Tell me, what don't you like around here?" Of course, sometimes the tenants will speak well of the building (or its owner). But more often they like to complain. They frequently hesitate to say good things because those kinds of comments could lead to an increase in rents.

Ask tenants, "What do you like least about living here?"

Some sellers add "Please do not disturb the tenants" to their advertising or promotional flyer. I would not disturb the tenants, but I would never let that statement deter me from talking with them.

Or, the seller or seller's agent may require you to sign a confidentiality agreement that restricts or prohibits you from talking with a building's tenants, leasing personnel, or other members of the service staff. If presented this type of requirement, I perform investigations prior to signing. Tenants and management personnel can provide a wealth of inside knowledge about a property. Refuse to prematurely sacrifice your right to tap into this source of inside information.

Problems with Tenants Bad tenants can ruin a good building. If some tenants create hassles for others, then you want to know about it before you structure your offer to buy the property. Problems within a property *and* problems with disruptive tenants can adversely impact vacancies, turnover, and rent collections.

Verify Lease and Application Data On occasion, leases and application data do not portray the true facts about a property's tenants. At times, sellers create phantom leases with false data. Absent outright fraud, though, talks with tenants might reveal rent concessions that aren't recorded in the written file that you were given to review. You might also find that some units are being sublet or are otherwise occupied by residents who aren't on the lease and may never have completed a rental application. Before you buy, put together a rent roll that's as accurate as possible. Otherwise, both your NOI and cap rate (risk rate) figures may err.

Generate Ideas for Improvement When you shop for property, divide the problems you find into two piles: economically unsolvable and opportunity laden. As your talks with tenants reveal the strengths and weaknesses of the as is property, you value it as it stands today. But also think how you might profitably improve it tomorrow. Through the eyes of a critical buyer, you itemize its faults and profit-draining negatives. Through the eyes of an entrepreneurial investor, you visualize ways to turn lead into gold.

Tenants will give you ideas for profitable improvements.

Your Competitive Market Analysis

Check the rent data an owner gives you against the rent levels of the competitive units that you've looked at. "You say you're getting $850 a month for your two-bedrooms? That surprises me. I haven't found any other 2/2s in the neighborhood that are asking over $775 a month. How do you attract renters who pay $850?"

You may not want to question so bluntly, but to negotiate a reasonable price for the property, you can't merely accept rent reports that test credulity. On the other hand, maybe the building does include some attributes that warrant higher rents. (Though I would hesitate to buy a property at the top end of a neighborhood

The market, not leases, will tell you the rental value of the units.

rent range. With fully priced rent rates, your ability for upside is heavily anchored.)

Leases or not, your knowledge of the market adequately informs you about the amount of rent collections that you can expect a property to yield in its current physical condition and with its current management practices. Likewise, to estimate rent collections after improvements, ignore sellers' puffery—"All you need to do is paint and recarpet these units. You can easily get another $150 a month. I would have done it myself, but I've just been too busy at the restaurant I own." Maybe the seller's right, but you won't know until you've actually visited and inspected a fair sampling of competing properties.

Set Your Rents with Market Savvy

Many owners of small income properties devote far too little effort to figuring out the rental rates that they should charge for their units. They underprice. They overprice. They don't make rent-enhancing improvements. They fail to adequately segment their tenants. They spend too much money on ineffective advertising and too little on target marketing. If they experience high vacancies, they blame a soft market. If they experience low vacancies, they pride themselves on their skill as landlords.

These mistakes (and others) flow from the same source. Property owners don't realize the profits they miss because they set their rents to reflect arbitrary judgment—rather than market reality.

Say you own a 12-unit building. You underprice by $25 a month. The market cap rate in this neighborhood is .09 (9 percent). How much does this rent shortfall cost you?

$$\begin{aligned}\text{Lost income} &= \$25 \times 12 \text{ units} \times 12 \text{ months}\\ &= \$3{,}600 \text{ per year}\end{aligned}$$

$$\text{Lost building value} = \frac{\$3{,}600}{.09}$$
$$= \$40{,}000$$

Those losses accrue when you underprice by just $25 per unit per month! Move that up to $50 or $100 a month, and your value loss for that property approaches $100,000 to $200,000. Underpriced rents can cost you a bundle of money. Overpricing, too, can also cost you plenty in terms of vacancies, turnovers, high advertising costs, low prospect conversion rates, property damage, and bad debts. Before you set your rent rates, contrast and compare the value propositions offered by competing properties.

The Myth of Market Rent Levels

If apartments were like cans of Campbell's tomato soup or bottles of Coca Cola, you might expect competing apartments to rent for the same price. But that's not the case because even similar apartment buildings and their individual units differ in dozens of ways that potential tenants find either appealing or unappealing:

- Views
- Energy usage/efficiency
- Square footage
- Natural light
- Ceiling height
- Quiet/noisiness
- Parking
- Room count
- Appliances (quality, quantity)
- Landscaping
- Quality of finishes
- Heat/air conditioning
- Decks/patios/balconies
- Color schemes/aesthetics
- Living area floor plan
- Closet space
- Storage space
- Kitchen functionality
- Kitchen pizzazz
- Entryway convenience
- Tenant demographics
- Tenant lifestyles, attitudes
- Lease terms
- Lighting
- Security

- Laundry facilities
- Fireplace
- Cleanliness
- Carpeting/floor coverings
- Electrical outlets
- Emotional appeal
- Physical condition
- Window coverings
- Types/style of windows
- Image/reputation

Consider a market rent range, not *the* market rate.

And this list doesn't address other important issues such as the amount of the security deposit (total move-in cash), house rules, the quality of the management, and last, but far from least, the multiple attributes of location. We deal with each of these items shortly, but the principal point is this: You can't intelligently say that your two-bedroom, two-bath units should rent for $675 a month—until you've compared your units feature-by-feature, location-by-location, services-by-services to competing units.

Rent Levels and Vacancy Rates

Assume you inspect four competitive 16-unit buildings (all units 900 sq. ft., 2/2s). You discover the following rents:

	Two Bedrooms	Number of Vacancies
Building No. 1	$600	0
Building No. 2	$650	1
Building No. 3	$725	3
Building No. 4	$750	4

In the real world, of course, you're not likely to find four perfectly comparable buildings. But I've structured this example to encourage you to see that low rents lead to low vacancies. High rents lead to high vacancies. So, if you look only at the rent levels in Buildings No. 3 and No. 4, you might conclude a market

Other things equal, the higher the rent, the higher the vacancies and turnover.

rent of around $725 to $750. However, after you match the vacancy rate to the rent rate, you see that both of these owners probably overprice their units.

The Myth of the Market Vacancy Rate

I've talked with property owners who have told me something like this: "I'm not going to increase rents this year. The market's too soft. Property managers report a market vacancy rate of almost 8 percent. I don't want to give my tenants a reason to move out in this type of competitive free-for-all."

These owners display market awareness but not market savvy. Although many owners raise rents in soft markets and end up with high vacancies and turnover, before you actually forgo the rent increase, look at market data more closely. Seldom do vacancies spread themselves equally among all locations, types of units, and price ranges. I've seen situations where a market vacancy rate in a mid-sized town shot up because of serious management/tenant problems in several large HUD projects.

What does *market* really refer to?

Absent that anomaly, vacancy rates still may cluster within certain segments of the market, while demand for other types of units remains brisk. For example, in my city, apartment rentals above $1,000 per month meet resistance because $1,000 a month will finance a reasonably nice house at today's interest rates (at the prevailing home prices in my area). Middle-income renters ask themselves, "Why rent when we can own?" Yet, within the $400 to $650 a month price range, the vacancy rate still sits below 4 percent.

The moral: Never accept "market" rent figures or "market" vacancy figures without first splitting those figures into market segments. Find out the what, where, who, and why of those numbers before you rely on them to price your rental units.

Think Rent Range, Not Rent Rate

From your rent surveys, think rent range. Compare each rental price with both the features and the vacancy factors within a building. Look for points of market resistance. Look for the low end of what's available. In any city, you will find a range of rents among somewhat comparable apartments. Sometimes you can explain these variances in terms of unit size, quality, or vacancy rates, but sometimes units are simply underpriced. Their rents sit well below the amounts the apartments could command—even in as is condition.

Raise Rents without Substantially Improving the Building

When you first take ownership of a building, you must abide by the terms of the lease that the previous owners signed with the current tenants. If a lease still has six months to run at $625 a month, you can't arbitrarily raise the rent. You can, however, raise rents as vacancies occur, as lease renewals come up, and through renegotiation of existing leases. Also, you might find buildings where many current tenants signed a one-year lease when they moved into the building two or three years ago, but now stay on in an informal month-to-month tenancy. With 30-day notice (or as otherwise specified by state or city law), you can raise the rents on these tenants.

Rent increases can immediately boost NOI and building value.

Confirm Your Suspicions

As an investor in income properties, look for properties with low rents relative to comparable competing units. When you find one, you've just found a pile of $1,000 bills.

How do you confirm your suspicion? Say your market rent survey leads you to believe that the units would fill up at a higher rent level, but you want more evidence. Here's what to look for:

1. *Waiting lists.* Some property owners (managers) take great pride in their waiting lists. They display their waiting lists as a badge of honor. In fact, more than anything else (except in tight rent-controlled cities), a long waiting list typically signals relatively low rents.
2. *Zero vacancies.* "We never have a vacancy. These units always rent the first day." Rents are probably too low.
3. *High conversion rate.* "These units rent fast. The first person who looks at one of our apartments nearly always takes it." Low rents probably explain why.
4. *Low turnover rate.* "We seldom suffer a vacancy. Many of our tenants have been with us for years." Wonder why?
5. *Tenant improvements.* "Our maintenance costs are quite modest. Our tenants often fix up their apartments and take care of things themselves. We rarely hear any complaints." Tenants with low rents seldom make a nuisance of themselves. They prefer to maintain a low profile.

If you can find a building at a reasonable price where you hear these types of comments, look closer. You can probably raise the rents—even without making substantial improvements to the property.

Why Owners Underprice Their Units

Owners underprice their apartment units for many reasons:

- *Low hassle.* It's easier to own a building that stays rented with complacent tenants.
- *Market ignorance.* Few owners perform competitive market surveys. Instead, they rely on hearsay, intuition,

and general news about vacancy rates, the economy, and inflation.

- *Charity.* "Many of our tenants live on fixed incomes. We wouldn't feel right forcing them to move by raising their rents."
- *Low or no mortgage.* Long-term property owners bought their buildings when property prices were much lower. They have now paid off (or paid down) their mortgage balances. Owners such as these feel no pressure to raise their rents. No alligators are chewing on them.

Over and over throughout my career, I've seen owners undermanage their properties in ways that fail to maximize their rent collections. Every owner wants low turnover, complacent tenants, and quick rent-ups when vacancies do occur. But at what cost? That's the real issue. Experience shows that these owners give up too much for too little. With an improved management and market strategy, you don't need to give away your units to keep them rented.

Investor Opportunities with Stage-of-Life Sellers

I particularly like to find buildings owned by older persons who now suffer burnout. After years of intensive hands-on management, they want relief. To achieve this goal, they purposely charge low rents. In turn, they reap the rewards of low hassle, low turnover, and low vacancy. But they give up cash flow.

Win-win with seller financing.

Here's where you profit. Offer to buy their property at its as is value with seller financing. In many cases, the mortgage payments you make will actually increase the amount of money these owners can put into their pockets each month.

A Look at the Numbers If the owners currently rent out the property to bring in gross rents of, say, $32,000 per year before

expenses, these owners are pocketing after expenses no more than $24,000 ($2,000 a month). Imagine, for example, that these owners would agree to sell based on a cap rate of 8 percent:

$$V = \frac{\$24{,}000}{.08}$$

$$V = \$300{,}000$$

Buy this building for 10 percent down (seller financing) and finance $270,000 over 20 years at an interest rate of 7.5 percent. You pay the sellers $2,175 a month or $26,098 a year. Not only are these sellers now free to take that trip around the world that they've dreamed about, they gain more cash flow from their property.

How the Numbers Work for You You might say, "Wait a minute. I'm the loser in this deal. How can I make money? Most of my current rent collections will go to the sellers. I'm facing a negative cash flow." You forgot—you're not a passive investor. You're an entrepreneur. You made this investment only because your market analysis showed that the present owners were undermanaging the property. Even without substantial improvements, you know that you can raise rents and boost NOI by 20 percent. After you've brought up the rents to where they should be, the value of your building will climb to $360,000.

$$\$24{,}000 \text{ (old NOI)} \times 1.20 = \$28{,}000 \text{ (new NOI)}$$

$$V \text{ (new value)} = \frac{\$28{,}000}{.08}$$

$$\text{New value} = \$360{,}000$$

Your before-tax cash flow will now look like this:

$$\text{Gross rents} = \$38{,}400$$

$$\text{Expenses} = 9{,}600$$

$$\begin{aligned} \text{NOI} &= 28{,}800 \\ \text{Mtg. Pymt.} &= 26{,}098 \\ \text{BTCF} &= \$2{,}702 \\ \text{Cash on cash return} &= \frac{\$2{,}702\ (\text{BTCF})}{\$30{,}000\ (\text{down pymt.})} \\ &= 9\% \end{aligned}$$

You not only have added $60,000 to the value of the building, your rent increases along with some increases in operating expenses give an immediate cash-on-cash return of 9 percent.

How High Can You Go?

Neither a market study nor the signals of underpricing (wait lists, zero vacancies, complacent tenants) tell precisely how far up you can take your rent increases. Your sure answer will come only by testing the market. Contrary to what you might expect, test higher and then back down if necessary. If you test low and immediately land a tenant, you still don't know the upper limit that you might achieve.

Let tenants tell you your maximum rental rate.

Test without Risk You can test high without much risk in several ways.

1. *Test advertise.* Prior to getting a vacancy, publicize the specifics of your units in the normal channels (classified ads, Craigs list, housing offices of local colleges, bulletin boards) at the highest rent you hope to receive. If no one calls, you're probably too high. If potential tenants do call, note how many and the intensity of their interest. Six calls the first day—with all callers ready to visit the property—usually indicates you haven't yet hit your top limit.

2. *Test advertise with showing.* Even more informative, when test advertising, follow through with test showings. Make arrangements with one or more of your tenants to permit entry into their unit(s). (Typically, if the tenant has given notice, the lease may—or at least should—give you this right.) During the showing, monitor the prospective resident's comments. Ask pointed questions. Learn all you can about your units and the apartment market as seen through the eyes of actual prospects.
3. *Ask the prospects to bid.* If you experience a vacancy, schedule a showing with multiple tenants. Then ask them, "What are you willing to pay?" In hot housing markets, home sellers have used this auction approach to sell their properties for as much as 15 or 20 percent over their original asking price.

Use the Call-Back Approach To conduct a market survey, you usually compare asking rents. You may see a for rent ad or sign, view the unit, and note the price at which the owner (or manager) has placed the property on the market. To understand the market, follow up your viewings after a week or two. Telephone the owner and find out whether the unit is still available.

Follow up to learn which competitors have found tenants.

To test the market in various rental categories (unit size, area of town, price range), get a copy of a newspaper that was printed two weeks ago. Go through the classified rental ads. Dial the numbers and discover which units have rented and which ones remain vacant. Use these data to detect market patterns. You might find strength in the $800- to $1,000-a-month two-bedroom market in the northwest area of town, but slowness elsewhere. What does the data signal about how high you might be able to price your units—without incurring prolonged vacancies?

Identify those unit features and/or locations in strong demand. When your property market looks great, test your rent increases at a higher level. When the market appears to soften,

don't reflexively cut rents. Figure out ways to make your units (or leases, the neighborhood, or the unit amenities) more desirable. (See Chapter 8.)

Selective Increases

Sometimes a property owner sets a rent schedule for a multi-unit property as follows:

1/1s	$650
2/1s	$785
2/2s	$850

Room count alone doesn't equal desirability.

In this type of pricing plan, all units with the same room count are priced at the same rental rate—as if room count alone determined desirability. On closer inspection, you find that some units provide their residents with better views, less noise, more convenient parking, or greater privacy. In those instances, price these more desirable units at a premium relative to the others.

Likewise, depending on your target market, upstairs units may command a higher price than downstairs units, or vice versa. Relative to lower-level units, upstairs apartments typically offer privacy, enhanced security, more natural light, and no noise from above (as in people clomping about). In contrast, some people prefer the first floor because it allows easier access to parking, no stairs to climb, and perhaps lower bills for heating or air conditioning.

Whether upstairs or downstairs, end units tend to deliver more appeal—hence, potentially higher rents. All in all, never price your units solely by room count. Not only do your units compete with other properties, they compete with each other. As you identify those advantages (or disadvantages) within your own building, price accordingly.

Dealing with Current Tenants

Tenants love low rents. But most know when they're getting the proverbial deal that's too good to last. When a property changes hands, the tenants in the building will expect to see their rents go up. Nevertheless, try to soothe their apprehensions.

Talk with Each Tenant Ideally, you will have talked with at least several of the tenants prior to buying the building. But now, to the extent possible, meet with each tenant. Establish rapport. Ask what improvements they would like. Get feedback. Explain that Mr. and Mrs. Former Owners subsidized the property operations. They could afford to because they had only paid $95,000 for the building 18 years ago. Besides, they no longer made mortgage payments.

Will these talks convince all of these tenants that you're a good person? Will these talks persuade these tenants to gladly pay you an extra $50, $100, or more each month? No. But, these efforts will work much better than a written letter that announces a big spike in their rents on the next renewal date for their rental agreement.

Provide tenants their *best* deal, not the cheapest deal.

PVP Revisited Throughout this entire discussion of raising rents, you may think that I have reneged on my principle of PVP—creating a value proposition for tenants that surpasses those offered by other property owners. If so, you've forgotten the second half of that principle: The value proposition that you provide must also yield you superior profits.

I have not urged you to *arbitrarily* raise rents. Through your study of the market, you have found that rent increases are justified relative to the features and pricing of competitive properties. Even at the higher rent levels, you're still offering as good (or better) a deal as most tenants could find.

In your efforts to appease the current tenants, rapport and explanations go only so far. At the end of the day, tenants will decide

to stick with your property primarily because they can't find anything else they like better for the same amount of money. Make sure you press this all-important point.

Your need for more rental income to cover high mortgage payments, property taxes, and insurance premiums actually counts for very little in the minds of your tenants. To retain tenants, first and foremost, make sure they understand the reality of the current market. If they haven't shopped for a place to live for several years, they might face sticker shock. In your one-on-one talks, bring these tenants up to date on rental rates. (Also, remind them of the costs and hassle that moving to a new residence creates.)

Can You Boost Your Rent Collections by Lowering Rents?

For the past six months, I have kept my eye on a rental house that I pass frequently. The house shows well, it's conveniently located in a professional neighborhood of single-family, predominantly owner-occupied houses within a 10-minute bike ride of a major university and the city's central business district (CBD). Yet for the past six months, the house has sat vacant. Why?

Because the owners started out by asking a rent of $1,500 per month. After four months with no takers, they dropped their price to $1,250, which is still the *asking rent* today. The *market rent* range for this house tops out at around $1,100 a month.

An Extreme Example of Overpricing and Market Ignorance (or Fanciful Dreaming)

Lower rents can boost profits.

This example of fanciful pricing in a weak upscale market, that is, an upscale rental for this town, illustrates the point. Sometimes you can lift rent collections and profits by lowering

rents. Because rent levels, tenant turnover, and vacancy losses tend to move up (or down) together, monitor the market to find trade-offs that maximize profits. If one or more of your units sit vacant for two or three weeks, you're probably over market. If you watch a unit sit vacant for two or three months, you're out of touch with market reality (or your promotion/leasing efforts fell woefully short).

A Purchase Opportunity

Sometimes an owner of a rental property gets into deep water without a life vest. He buys a property, underestimates its expenses, and tries to salvage his cash flows by increasing rents. Of course, these rent increases (absent a market justification) make matters worse. Vacancies climb to 20 percent. Rent collections fall. More tenants give notice that they won't renew their leases. Turnovers mount. The distressed owner misses several mortgage payments and begins to be pressured by the lender's lawyers.

Although this situation spells trouble for the distressed owner, it spells opportunity for the entrepreneurial investor who can solve the problem: To get rent collections up, reduce rents.

It's far better to achieve 95 percent occupancy with a rental rate of $800 a month than struggle with 80 percent occupancy at a rent level of $850. Consider the figures below for a 24-unit building:

Above Market Rents (80 Percent Occupancy)

1. 24 (units) × $850 × 12 × .80 = $195,840

Top of Market Rents (95 Percent Occupancy)

2. 24 (units) × $800 × 12 × .95 = $218,880

The rent collections at the lower rent of $800 per month actually yield more cash. But look what happens if we charge rents of $725 a month to try to achieve (or sustain) that mythical ideal of zero vacancies (100 percent occupancy):

Below Market Rents (100 Percent Occupancy)

3. 24 (units) × $725 × 12 × 1.0 = $208,000

Owners who maximize occupancy don't necessarily maximize profits.

The breakeven point in rents, vacancies, and rent collections will vary over time by area, price range, and building features. Yet, the basic principle holds in all places at all times: Monitor the market. Search to determine those rental rates that maximize the net income of the property if your goal is to maximize the value of the property.

Time-Sensitive Rental Markets

In some locations, you achieve peak rents only if you get your properties rented within a window of opportunity. In most college towns, vacancies in August typically rent faster and at higher rents than in, say, November or June. In Sarasota, Florida (and other winter vacation spots), December may prove to perform best. In April, the snowbirds have left and vacancies proliferate. In the Hamptons, the summer brings top rents. But you better have your leases signed by spring because in May and June, owners feel desperate and slash their asking rents.

On occasion, in extremely tight markets, you can extract premium rents after the period of peak activity ends. In those cases, because virtually all properties now have tenants, those rare vacancies that do occur may be able to take advantage of their scarcity—providing that the market still includes many renters looking for a place to land—after the music has stopped.

Learn the rental season of your local market.

The moral: Know the timing of the markets where you own properties. Some areas cycle through peaks and valleys every year. If your window of opportunity is closing, cut rents sooner rather than later (or change your value proposition).

CHAPTER 8

Build Equity Fast with Sharp Interiors

Build equity fast when you recognize how to collect more rents from an existing property. But to really accelerate your wealth building, create value for your properties and your residents through various improvements and changes. Frequently, you can bring in more rents, cut expenses, and lower a building's cap rate—all at the same time. By simultaneously achieving all of these goals, you can jump the value of a property by 30 to 40 percent within a period as short as 24 months. But you must work for this reward.

The Entrepreneurial Imperative

Hundreds of thousands of investors have decided to shift their asset allocation away from stocks and toward real estate. Given the exaggerated hopes and fantasies that 50 million investors hold for stocks, I believe this rush to real estate will continue. To restate the problem:

Too Many Investors

Too many investors are chasing (and will continue to chase) too few good properties. I have searched for income properties

primarily in Florida, but also in other areas of the country. The only *instant* equity deals (that is, value creation through quick rent increases) that I've found are in low- to moderate-income properties. Although I have earned huge returns in the low to moderate market, these properties no longer fit my objectives. (Nevertheless, I still believe that these properties make a great starting point for beginning investors because they yield high cash flows and often sell at affordable prices.)

The low hanging fruit gets picked quickly.

Notwithstanding the low to moderate market, to get that juicy 30 percent boost in value in today's market will typically require entrepreneurial talents. To score big, blend together market savvy, creativity, and a true desire to deliver a better product to your target market. You must see what others don't see. Perform at that higher level where most people won't perform.

Too Few Sellers

Recently I saw the following ad:

> West side of Bradenton: Duplex, Triplex, 8-plex or 29 units. 6.4 GRM, positive cash flow—20% down. Bronson Realty—(987) 654-3210.

I called the first day and left a message that I wanted to see the properties. No response. In follow-up about two weeks later, I talked with the listing broker. He told me that he had received 60 calls on the property and apologized for not getting back to me. But then, even worse news. The seller had withdrawn the properties from the market in favor of refinancing. "Why should this owner sell and pay taxes when a cash-out refinance will put just as much money in his pocket?" the broker asked rhetorically when relaying the investor's reasons for pulling the property off the market. Besides, "If I sell," investors say to themselves, "where will I be able to reinvest the money that beats the returns I'm now earning with these income properties?"

Not Words of Discouragement

Don't misinterpret. I'm not trying to discourage you. Quite the opposite. I encourage you to start now so that in 5, 10, or 15 years (depending on your goals and commitment), you will sit comfortably in a financial position similar to today's owners who bought 5, 10, or 15 years ago.

When you look at properties today, ignore thoughts about the past opportunities you missed. Do not let the seller's "ridiculously" low cap rate and "absurdly" high asking price deter your search. Instead, focus on the value that you can create for that property. Think how much equity you're going to build in that property as you figure out ways to lift its NOI. If your careful analysis doesn't reveal potential for the property at the price the seller requires, then move on to the next seller.

Today's high prices will seem low as you look back in 2018.

In all markets, some owners hit financial hard times. They mismanage their properties. Ill-advised financing turns against them (e.g., option arms). They get divorced, suffer burnout, become complacent, or see other ventures they want to pursue. When you look, you will find motivated sellers with opportunity-laden properties. Even better, after you become known in your local market, the deals will come to you. After I had been buying properties for only two or three years, the sellers from which I had bought recommended me to their landlord friends who wanted to sell. Often, these referrals brought easy deals without the friction of a real estate commission.

Select the qualified tenant who most wants the unit.

Your Target Market

Nearly every book on property management tells you to thoroughly screen your tenants; then select the applicant(s) who are *most* qualified. I differ with this advice. I believe you

should select the most appreciative tenant who is qualified. The most appreciative tenant is the one who most highly values what you're offering, and is willing and able to pay the highest rents (or perhaps commit to a longer lease period).

Visualize Your Tenants

Perhaps owners who offer a generic property to a generic tenant can select customers by their credit scores and references. But entrepreneurs go further. To whom do you want to appeal?

- Families with small children
- College students
- Seniors
- Nurses who work at the nearby hospital
- Young professional singles who live as roommates
- Workers at the local factory
- Who else?

Or think in terms of amenities such as quiet, natural light, spaciousness, storage, or convenience. When you study the market (competing properties along with the dislikes, preferences, needs, and wants of various types of tenants), you're not attempting to discover market rent levels per se. You want to discover features and/or attributes in high demand by certain people, but are scarcely found. You might classify property owners into five categories—those who:

1. Fail to provide the minimum management necessary to preserve current operation.
2. Never do anything more than is absolutely necessary.
3. Maintain the property enough to preserve its condition.
4. Cosmetically enhance the property according to the owner's tastes.
5. Entrepreneurially enhance the property.

Why do entrepreneurs outperform the other types of property owners? Because entrepreneurs visualize their future tenants. We can say that entrepreneurs try to get inside their customers' minds. They ask, "How would my preferred tenant react to . . . ? Would they react with an excited 'Wow!' a bland 'It's okay,' or a repulsive 'Ugh . . .'?"

Your Suggestion Box

In the pages that follow, you will read dozens of ideas. Review these ideas as you would those you might pull from a suggestion box. Some you can use immediately. Some you can't. But don't throw any away. They may prove useful later.

Learn to envision what others fail to see.

Each time you evaluate a property as a potential investment, pore over these ideas. Ask yourself, "For the types of tenants that I have in mind, would this change bolster the value proposition that I could offer? Will this change create a competitive advantage for this property that will bolster my bottom line?" Look at properties with an entrepreneurial eye, and you will see profit potential that escapes the notice of most sellers and most other investors. In today's market (and most certainly in tomorrow's market), that's how to find great deals.

Figuring Payback

When you find a property that warrants improvement, figure your payback with a variant of the value formula that we've been using.

$$V = \frac{NOI}{R}$$

Only in this instance, the V refers to value created and the NOI refers to the additional net income that your property will bring in after you have performed your magic. Say your improvements add $100 a month per unit to NOI. If the applicable cap rate is 10 percent, through your work, you've created $12,000 in added value for that unit.

$$V = \frac{\$1{,}200\ (12 \times \$100/\text{unit})}{.10}$$

$$V = \$12{,}000$$

How much should you invest to achieve that $12,000 per unit increase in value? I figure a 2 to 1 ratio. For each $1 in value created, I prefer not to invest any more than 50¢ (often much less). But technically, you could invest up to 99.9¢ (or a total of $11,999 in this instance) and you would still net a profit.

Fast Buck versus the Last Buck

Generally, most entrepreneurs go for the sure buck, not the last buck. In other words, through your improvements, don't improve everything. Instead, through your study of the market, identify those changes that create the most revenue for the least amount of outlay and the lowest risk. Your tenants operate on a budget, and so must you. The closer you push your rents toward the top end of the neighborhood (or the top end of your tenants' willingness and ability to pay), the more you risk overshooting your target.

Set Your Budget for Improvements

To decide the amount to allocate to changes within a property, imagine that after your review of the property and the market, you list these possibilities:

Improvement	Cost	Added Rent/Mo.
Thorough cleaning	$ 400	$ 75
Paint and carpet	2,000	50
Kitchen/bath redo	5,000	100
Ceiling Fans	250	5
New windows	3,000	35
Fireplace	2,500	25
Kitchen appliances	1,250	25
Covered parking	1,500	15
Balcony/deck	2,500	10
New HVAC (energy efficient)	2,000	20
Total	$20,400	$360

All of these improvements would cost a total of $20,400 and would boost your rents by $360 a month. Using the widely accepted formula, you can see that these improvements will add about $43,200 to the value of each unit.

$$V = \frac{4{,}320\ (12 \times \$360)}{.10}$$

$$V = \$43{,}200$$

Is this number reasonable? Not likely. Unless you're dealing with high dollar rentals in an expensive area, you've raised your rents too high. Go back and choose those improvements that will give the highest return your tenants are willing to pay. You might wean your possibilities as follows:

Improvement	Cost	Added Rent/Mo.
Thorough cleaning	$ 400	$ 75
Paint and carpet	2,000	50
Kitchen/bath redo	5,000	100
Kitchen appliances	1,250	25
Total	$8,650	$250

Place these numbers in the value equation and you find:

$$V = \frac{3{,}000\ (12 \times \$250)}{.10}$$

$$V = 30{,}000$$

Even if you boosted rents by only $200 per month, your value created would still provide a payback of about 3 to 1.

The Sum Effect

To decide what improvements to make, imagine the sum effect of your changes on the tenant's willingness to rent the property. Sometimes you could include some low payback items (on an individual basis) for the synergistic or "nice touch" effect they add to the project.

Aim your improvements toward an overall effect.

To work through the numbers, you can't precisely calculate cost and return. But, if you rely on this methodology, it will force you to think through your possibilities. Yet, avoid overdoing the project. Use the V = NOI/R method to calculate the most bang for your buck.

The Interior of the Units

Imagine yourself living in the unit. What changes would you want?

Most investors breeze through a property and then size it up like this, "Well, these units should go for maybe $550 a month, $575 tops. Let me run the numbers and see how they come out." Instead, to lay the foundation for creating value, you would not dwell exclusively on the monetary value of the rental unit; rather, closely examine it as someone else would (from your

target market) who is considering this apartment for their home. In fact, preinspect the apartment even more closely than many residents would. Units that eventually disappoint their residents lead to complaints and turnover.

Sharpen the Aesthetics

As you walk into the unit, are you met with a bland neutrality? Do you see faded paint, scuff marks, outdated color schemes, cheap hollow-core doors, nail holes in the walls, worn carpeting, torn linoleum, old-fashioned light fixtures, cracked wall switch plates, or stained sinks? If you answer yes to any or all of these questions, great! You've found an easy way to create value.

Pay Attention to Kitchens and Baths To wow your tenants, bring in Martha Stewart to redo the kitchens and baths. Flip through the pages of those many kitchen and bath magazines. Look for that right combination of materials and colors that will create a light, bright, cheerful, and inviting look. Eliminate those harvest gold appliances, the chipped and stained sinks, and that cracked glass in the shower door.

As you inspect the kitchens and baths, focus for at least 10 seconds on each of the following:

- Floors
- Ceilings
- Sinks
- Toilet bowl
- Windows and window sills
- Electrical outlet plates
- Lighting
- Faucets
- Walls
- Cabinets
- Cabinet and drawer handles
- Appliances
- Countertops

When you focus for 10 seconds on each ingredient in these rooms, you notice everything that blends together to give these rooms their overall flavor. Throughout the entire apartment, details

count. But they especially count in the kitchens and bathrooms. The right pizzazz in the kitchens and bathrooms can transform a ho-hum unit into a showplace.

How much will this transformation cost? If you spent $25,000 to remodel your own kitchen, you may think pizzazz in a rental unit would break the bank. Not true. You can accomplish showcase makeovers with an outlay of between $2,000 and $5,000. You can replace sinks, cabinetry hardware, toilet bowls, and toilet seats for relatively little money. As to cabinetry, often a refinish (not a full replacement) can achieve your goals.

Cleanliness Generates Profits Do you want to attract tenants who will care for your properties? Then thoroughly clean the units as if a drill sergeant were about to perform a white glove inspection. Do not think "rental property." Think "home."

Clean everywhere. Remove the dirt, dust, cobwebs, and dead bugs from all corners, baseboards, light fixtures, and shelving. Pull out all kitchen drawers. Dump the bread crumbs and other accumulated debris. Wipe them clean. All windows and mirrors should sparkle and shine. Look closely for grime in the shower and shower door tracks. Scrape the rust out of the medicine cabinets and repaint where necessary. Eliminate all foul odors. The apartment should not only look fresh and clean; it should smell fresh and clean.

Some owners of income properties clean their units superficially. They figure, "It's only a rental. Why go to all of that trouble and expense?" In fact, cleanliness pays back more than any other improvement. It's the easiest way to give your properties a competitive edge. More importantly, the best tenants pay for cleanliness. You achieve two goals: more money from better tenants.

Cleanliness pays back at least tenfold.

Natural Light and Views If your units seem dark, brighten them up. In addition to color schemes, add windows or skylights. If you're lucky, you might find buildings with 10' ceilings—now

reduced to 8' because of suspended acoustical tile. For reasons unknown to me (energy conservation?), dropped ceilings became popular in the 1970s. Today, they're ugly and outdated. Rip out those dropped ceilings. The rooms will seem larger and brighter. Also, in rooms with high ceilings, install clerestory windows to bring in more light.

For first-floor units, enhance the view with landscaping or fencing. For upper-story units, think long term. Plant trees. Create a view by moving a window. Ugly views turn off most tenants. Pleasant views provide good selling points. Ameliorate (or eliminate) the former and enhance the latter.

Special Touches

For those special aesthetic touches, try chair railings, wallpaper borders, upgraded door handles, paneled doors, and wood stains (rather than paint). Upgrades in light fixtures, too, can help you add pizzazz. Newer forms of lighting seem to be gaining popularity in some areas for both form and function.

Add special touches that impress.

Generate ideas for special touches not only from the many types of decorating and remodeling magazines, but also visit new model homes and newer upscale apartment, townhouse, and condominium developments. Skip the lavish special touches or you will cut into your profitability. Nevertheless, a few "gee whiz" features help rental prospects favorably differentiate and remember your units vis-à-vis the other properties they inspect.

Safety, Security, and Functionality

Often safety and functionality match up with the number and capacity of electrical outlets. Older buildings, especially, lack

enough outlets and amperage to safely handle all of the modern household's plug-in appliances, computers, printers, fax machines, and audio/video (a.k.a. home theater centers). Many renters don't notice this obsolescence until after they move into a unit. Then they solve the problem with adapter plugs and roaming extension cords. If the property lacks electrical capacity, plan an upgrade.

Other Issues of Safety and Security Other safety issues pertain to smoke alarms, carbon monoxide detectors, fire escape routes, door locks, first-floor windows, and first-floor sliding glass doors. Environmental health hazards may exist because of lead paint, asbestos, or formaldehyde—any of which may be found in building materials used in construction (or remodeling) prior to 1978. Insist on written seller disclosures about the presence of any hazards. If the building is suspect, don't buy it without securing the advice of an environmental expert.

Don't gloss over potential environmental problems. Get expert help.

Hazardous substance improvements seldom pay back with higher rents. To profitably deal with environmental issues, you must secure a large discount in price at the time of purchase. As to security against break-ins, test windows and doors to verify that they lock securely. Dead bolt door locks work best. Entry door peepholes also provide security.

Tenants want to feel safe in their homes. If doors, door locks, and windows seem flimsy, many tenants won't rent the unit—regardless of its positive features.

Stairs, Carpets, and Bathrooms Attend to any steps or stair railings that may be loose or dangerous. Frayed carpets and bathtubs without no-slip bottoms and handrails also provoke falls. Remedy every safety or security hazard within the property. Even when a repair or modification doesn't lift your rent collections, it protects tenants from harm and reduces the risk of a lawsuit.

Rightsizing Room Count/Room Size

Robert Griswold (*Property Management for Dummies,* Wiley, 2001) tells of buying a 12-unit building composed of all two-bedroom, one-bath apartments. Because the building was located just 1½ miles from a college campus, he originally thought he would attract two students (roommates) to the units. But to his surprise, that strategy failed.

"Although many prospective tenants looked at the units," Griswold reports, "our lease-up went slow and vacancies remained high. Clearly, I was trying to define and force the rental market and prospective renters to adapt to my perception of their needs. [When it dawned on me that I would have to change my plan] I began to carefully review the comments of prospective tenants and actually listen to their needs. I found that there was a strong market for faculty and graduate students but they preferred to live alone."

Listen carefully to tenant feedback.

Griswold then discovered that faculty and graduate students wanted quiet and a place to work or study without noise or interruptions from roommates. With this more accurate picture of needs, he says, "I realized that I could market these very same two-bedroom, one-bath units to this new target market. . . . [So] I revised my marketing effort and changed my ads in the college newspaper to read, '1-Bedroom plus den.'"

With that change in advertised room count, Griswold reports that he was still able to reach his originally intended market, but only after "changing" the product to better fit what that market wanted. Griswold's advice matches perfectly the theme in this book. He says, "Remember: Look at your rental property from the perspective of the most likely tenants. Then promote and accentuate the features of your rental property that will prove of greatest interest to that market."

Rightsize the Easy Way Fortunately, Griswold was able to rightsize the room count (two-bedroom/one-bath into one-bedroom/

Search for the most profitable room count.

one-den/one-bath) without making any expensive changes to the physical property. Great idea! But you can also rightsize the room count by removing walls, combining units, or subdividing units. At one time in Manhattan, four-bedroom apartments generated strong demand against short supply, whereas two-bedroom apartments experienced slow demand against a glut of vacancies. Recognizing this market imbalance, an entrepreneurial investor bought a building of two-bedroom apartments at a steeply depressed purchase price and then combined the two-bedroom units into the much sought-after four-bedroom apartments. He next quickly rented the new larger units at premium prices.

Downsizing Can Also Work As a rule, the profit potential from rightsizing the room count tends to favor downsizing over upsizing. That's because smaller units typically rent for higher prices per room than larger units. Consider the following rent schedule:

Unit Type	Monthly Rent
Efficiency	$ 950
1-bedroom/1-bath	$1,100
2-bedroom/2-bath	$1,350

In a rental market where this type of rent spread exists, you might convert two-bedroom/two-bath units into efficiencies. If in this situation, you could cut each two-bedroom apartment into two efficiencies, your rent collections for that space would jump from $1,350 per month to $1,900 per month. Of course, you would need to factor in the conversion costs to determine whether your payback makes enough money. But the principle holds: At times, market supply/demand imbalances create profit opportunities: So rightsize the room counts and magnify your rent collections.

Rightsize the Room Sizes Have you ever walked into a property and found some rooms too large and others too small? It seems today that in many houses builders construct a huge great room

along with a huge master bedroom and bath, and then complete the house plans with three or four dinky-sized bedrooms. The house lacks a sense of proportion, which evidently is what some homebuyers like.

What sense of proportion should an apartment display? The answer varies by tenant segment, price range, and timing (that is, tastes today differ from those of 10, 20, or 30 years ago). Thus, as market supply and demand changes, opportunities arise for entrepreneurs to notice room size imbalances. Buy an out-of-style building; then rearrange the internal space in the units to command more appeal to today's intended market segment. Many tenants today prefer large, bright rooms to that cubbyhole feel of more smaller rooms within the same square footage.

Create More Storage

The self-storage business represents one of the fastest growing types of properties. We've all become pack rats. "Throw it away? Why? I might need that sometime."

Many tenants will pay for more storage space.

Talk with tenants. Talk with homeowners. Many will tell you the same thing. "I like my home, but we lack enough space for storage." To add appeal to your units, add storage space. To do so, think about storage in three ways:

- Bring dead space to life
- Increase the efficiency of existing space
- Create new storage space external to the apartment units

Bring Dead Space to Life I will illustrate with what seems trivial, but in fact creates a lasting favorable impression. Look at the cabinet under your kitchen sink. You see a small gap between the front panel of the cabinet above the door and the sink. In other words, dead space. How might you use that space? Install a small

pull-down compartment to stow a bar of soap, a sponge, and some Brillo pads. No more sink clutter. Whenever I show this little innovation to other people, I always get a "Wow, isn't that neat," type of response.

Okay, it's trivial. But it illustrates the point. All properties include wasted amounts of large and small dead spaces that with creativity you can bring to life:

- Under stairs and stairwells
- Bay windows with storage built under the window seat and under the outside of the window
- Garden windows
- On the tops of kitchen cabinets
- Dead-end cabinets
- Walls suitable for shelving
- Recessed storage between studs (as with an in-wall medicine chest)
- Kitchen hanging bars for pots and pans

These ideas are just sample possibilities. Carefully inspect any property and then ask, "Where are the dead spaces that I can bring to life for purposes of storage?" You will find them.

Make existing space work more effectively.

Rightsize Existing Storage Space To illustrate this point, recall the California Closet Company (CCC). As this innovative firm has proved, you can double (or triple) storage capacity without adding one square inch of new space. Simply reorganize and redesign the raw space that already exists. Although founded as a closet company, CCC now redesigns garages, offices, workshops, and kitchens. Put these same organizing principles to work and you'll truly enhance the appeal of your rental properties.

You can also use the same space for more than one purpose. One good way to achieve this end is through use of a Murphy bed

that folds up into a wall. It increases usable floor area, but you can also install shelving alongside the bed. You can either use the wall cavity or create a new, larger cavity by bringing a new wall out that is aligned with the Murphy bed.

Create New Space External to the Unit Why let your tenant's dollars run off to a self-storage company? Create more storage right on your property that will bring in additional revenue. (We will discuss this topic along with other ideas to generate more income from your properties in Chapter 9.)

Check Noise Levels

Noise stirs up problems within apartment buildings. Does sound from a television or stereo carry into other rooms? Bring along a portable radio on your building inspections. Place it in various rooms. Turn up the volume. Do the walls provide enough soundproofing? Families and roommate tenants want privacy and quiet. If your property fails to offer these essentials, your property will lose its appeal.

Even more important, will your tenants hear neighbors or neighborhood noise? Again, people pay for quiet. They discount heavily for noise.

Although potential neighbors and neighborhood noise are especially damaging in areas filled with multifamily housing, as noted earlier, predominantly single-family areas may also feature loud stereos, barking dogs, and NASCAR wannabes. Does the drum corps of a nearby high school practice outside three or four hours a day? Visit the property during periods of high traffic or peak noise. Don't assume that a peaceful-looking neighborhood actually offers peace and quiet. Verify before you buy.

Seek written disclosures from the seller of the property. Talk with neighbors and tenants. Determine whether anyone has tried to enforce quiet by complaining to city government, a homeowners association, or by filing a nuisance suit? If you buy the property,

could you effectively invoke any of these remedies against tenants (or homeowners) in other nearby properties? Can the building incorporate more features to reduce noise that emanates from either outside or inside the building? Suppress noise into quiet. You will create value.

Create a home, not merely a rental unit.

Overall Livability of the Unit

Remember that you are not running a rental property. You are providing people with a home. In your analysis of the units, weigh the overall livability of the units for your intended market of residents.

- Do the units offer enough square footage?
- Are the units spotlessly clean, fresh, and bright? Do they smell clean and fresh?
- Does the room count represent the most profitable configuration of space?
- Do the aesthetics of the units excite with emotional appeal?
- Does the unit bring in enough natural light?
- What views will the tenants see from inside the units looking out?
- Do the units offer generous amounts of closets and storage space?
- Are the units quiet?
- Does the floor plan make for efficient traffic flow?
- Will tenants feel safe and secure within the units?
- Do the kitchens and bathrooms offer a competitive pizzazz?

When you transform rental property units into homes, you achieve high rents and low vacancies.

CHAPTER 9

Generate More Income

Great livable units that excite with pizzazz and emotional appeal will keep your building full of tenants who will gladly pay premium prices. But before sharp interiors can woo your prospective tenants, you must get them to keep their appointments to inspect the "homes" you offer. Nothing accomplishes this goal better than curb appeal.

You can write an award-winning newspaper ad that will make your phone ring. Yet, this literary prowess will fall flat when great tenants pull up in front of the building and immediately begin to ask themselves, "What are we doing here? This place is nothing like I imagined. Do you think we should go in?"

"Nah. Why waste our time? This place is a dump. We shouldn't even think about living here."

Advertise your property with a well-kept outstanding exterior.

Your Building Sends an Advertising Message

Hundreds (or perhaps thousands) of people pass by your property each week. What will they notice? Will it appear as that rundown "rental" of the neighborhood, a nondescript plain Jane,

or might it elicit this response, "Isn't that building kept up well? Those flower gardens and brick walkways seem to reach out and invite people to come inside."

If you want your building to generate more income, create an inviting exterior. Create award-winning publicity with knock-out curb appeal. Not only will an attractive, well-kept exterior appeal to a better class of tenants but it also increases tenant satisfaction and reduces turnover.

Clean Up the Grounds

When you take over a property, carry out a detailed cleanup of the grounds, parking area, and walkways. Pick up trash, accumulated leaves, fallen tree branches. Erect a fence to block the view of the dumpsters or other trash disposal areas. To the extent the current leases or municipal law permits, get tenants to remove any inoperable vehicles from the parking lots, parking spaces, or driveways. If such vehicles are parked on the streets, ask the city government to post them and tow them.

Porches, patios, decks, and yards should remain free of useless household items such as discarded furniture, appliances, car parts, motorcycles, bicycles, kids' toys, and all other items that give the property a dilapidated, uncared-for look. Step one toward curb appeal requires a super neat and debris-free appearance.

Over time, landscaping provides huge returns. Start now.

Yard Care and Landscaping

Here's where you can easily add great value to your property. Tenants and homebuyers alike love a manicured lawn, flower-lined walkways, mulched shrubs, and flower gardens. With landscaping, you can turn an ugly duckling building into a showcase property. With landscaping, you can create privacy, manufacture a gorgeous

view looking out from the inside of the units, or eliminate an ugly view. If you hold your property for a three-to five-year period (or longer), put in those small plants, shrubs, flower gardens, and hedges now. When you sell, you can earn a return of 10 to 1.

Plant low-maintenance grass and vegetation. You don't want to pay a yard maintenance company a small fortune. Maybe one of your tenants might enjoy yard artistry, and you could exchange a green thumb for rent. For lawn and landscape ideas that work best in your area, talk with landscape companies. Avoid buying plants just because some nursery has put them on sale and you can load up your SUV on the cheap. Learn what plants will grow best with the least work and lowest chance of disease and early death.

Look for good places to plant trees. Over the mid to longer term, well-located trees give strongly favorable payback. Learn their height and width at maturity. Many amateurs plant young trees and shrubs too close to a building.

Sidewalks, Walkways, and Parking Areas

Replace or repair cracks and buckling that appear in sidewalks and parking areas. Remove all grass or weeds that grow through the cracks. Edge the areas where the yard abuts concrete or asphalt. Neatness pays. Overgrown grass and weeds stain the curb appeal of a rental property—precisely because these types of blemishes signal that the property is a rental.

Remove oil stains from parking areas. If parking for the property proves inadequate to the number of cars the tenants own, create more parking area. Don't allow tenants (or anyone else) to park on the yard. Mark all parking areas and restrict all parking to those designated areas.

Fences, Lampposts, and Mailboxes

To bolster aesthetics, privacy, and security, use quality fencing. A rusted, rotted, or half-falling-down fence blemishes the property.

Clean up the mailbox area and keep it clean.

Likewise for rusty lampposts with broken glass light fixtures.

For a nice decorative touch, add a white picket fence or a low-level stone fence in the front of the building. If the building houses a cluster of mailboxes, make sure the mail area is kept neat and the mailboxes present a good first impression. Careless owners allow the mail areas to accumulate with junk mail, advertising circulars, unwanted magazines, and other items from the post office that are addressed to persons who no longer live in the building. If each unit has its own mailbox, replace them with attractive new ones. Replace the unit numbers, too.

The Exterior of the Building

Along with site improvements, attend to the exterior of the building(s). Signal to prospective tenants that this owner takes good care of his property. To evaluate the building's exterior and generate ideas for improvements, apply these four criteria:

1. Appearance
2. Condition
3. Building materials and maintenance expense
4. Site placement (how the building is oriented on the site)

Appearance To inspect the building exterior, move back at least 50 to 100 feet. Place the building in perspective with the site and with other properties in the neighborhood. Does it fit in? Does the architectural style give the property an appealing uniqueness, or is it a simple rectangular box design with no windows on either side? Have a half dozen other apartment buildings in the neighborhood been built with the same bland design? What improvements can you make to the building that will enhance its appearance and favorably set it off from nearby properties as well as other buildings?

Stand away from the property. Evaluate each detail that contributes to (or detracts from) the exterior.

The roof. Is it discolored? Are leaves piling up? Are plants growing on the roof or out of the rusty gutters? A roof can influence the exterior aesthetics of a building because it frequently occupies 30 percent or more of what you see when you face a building. Clean it up so that it shows as little wear as possible.

If your remedial efforts can't improve the appearance of the roof—and you're planning to quickly flip the property—consider replacing it. As the late real estate expert Bob Bruss pointed out, a new roof probably won't give you a dollar-for-dollar payback, but it will enhance the property's marketability. On occasion, such loss leader repairs can work synergistically to create an overall effect that will help your property rent or sell for a higher amount.

Cosmetic makeover. Can you imagine ways to enhance the building's appearance with shutters, flower boxes, dramatic front door(s) and entryways, new or additional windows, fresh paint, a contrasting color for trim, or accenting the design with architectural details? How well does (or could) the property's exterior distinguish it from other comparably priced rental properties? Do you rate its appeal as great, so-so, or awful? List other possibilities for profitable improvements.

Think of features that set your property apart from its competitors. Look for features that wow your target market and passersby.

Use your inspection to negotiate a lower price.

Exterior Condition: The Professional Inspection To avoid too many loss leader repairs, hire a professional inspector to detect potential problems with any property you offer to buy. Generally, though, you won't order an inspection report until after you've signed a purchase contract that includes an inspection

contingency clause. Nevertheless, prior to that step, perform a close preprofessional inspection. Your microexamination of the exterior (and interior) serves three purposes.

1. *Purchase negotiations.* To achieve the best price and terms, justify your offer. When the seller says, "What! You're offering me $415,000! Buildings like this are selling for $60,000 a unit." "Yes," you respond. "But those buildings are in near perfect condition. As we discussed, this property is going to need. . . ."
2. *Weed out losers.* When your preinspection identifies problems but the seller won't accommodate you with concessions, stop wasting time. Say sayonara. Move on to the next possibility.
3. *Education and understanding.* When you bring a professional inspector in, don't settle for a mere inspection. Go for an education. Use your preinspection notes to quiz the pro. Learn how to spot problems; learn the reasons for the problems, figure out remedial alternatives and, most importantly, cost-effective means to prevent them.

Materials and Maintenance Each geographic area has its own types of construction materials that are popular and effective for that locale. Wood, brick, brick veneer, adobe, concrete block, stucco, and steel are examples. In addition, some buildings are built on a pier-and-beam foundation; others sit on concrete slabs. Windows and roofs differ, too. Crank-style aluminum awning windows used to be popular in some warmer climates but seldom found up north. In California, you see tile roofs; in Maine, that type of roof is rare.

Evaluate the quality of construction and building materials. Regardless of the specific types of construction materials used in your area, you can be sure that they vary widely in costs, function, and desirability. Before buying, talk to knowledgeable builders, contractors, or building supply companies to learn the differences

between high-end, mid-range, and low-cost building materials. Maybe you can talk with someone who has built new construction. They may have spent months shopping for and comparing materials. Unlike your tenants, you've got to move beyond appearance. Savvy investors don't judge the quality of a building by its paint job.

Favor low maintenance buildings.

Maintenance: time, effort, and costs. Apart from the quality of construction materials, consider how much time, effort, and money it's going to cost to maintain the building. Growing up, I recall that every three or four years we had to scrape peeling paint with a wire brush to prepare our house for its next coat of paint. Now, today's durable paints, stains, and materials often last 10 years or longer.

When you repair or renovate, go with low- or no-maintenance improvements, even if they cost more. You, your eventual buyers, or your tenants don't want to fool around with property maintenance. Low- or no-maintenance features boost your property's net income and help it retain its pleasing appearance for a longer period of time.

For lower- to moderate-priced properties, I favor durable siding and eaves. In the South, I like concrete block. Slap on a coat of paint every 10 to 20 years and that's it for exterior maintenance. As to gutters, old-timers love them. I hate them. The best way to deal with rusty, leaf-filled gutters is to rip them off and not replace them. Place a rain diverter on the roof above the exterior entryways.

Tenants love units with beacons of natural light.

I possess little talent, inclination, and time to take on the chores of property repair and property maintenance. With today's materials, that distaste erects no barriers to owning investment properties.

Building Placement As you look at a building from the outside, note how it is situated on the site. Are the windows positioned to bring in natural light? How about privacy from neighbors? Can residents sunbathe in the backyard without prying eyes invading their privacy? Are the sleeping areas of the units protected from street noise? How do prevailing winter winds (or summer breezes) strike the building? How do these affect resident comfort and energy bills? In North America, a southern exposure with large windows will bring in the winter sunshine and reduce heating costs.

Safety and security. Do you spot any safety or security hazards? Is the building situated such that residents can enter publicly viewed areas? I once owned a building where entrances to two of the units required residents to walk down a long narrow passageway with a tall fence on one side and a hedge row on the other. Although I never thought about it back then, today I would make sure that that passageway was well-lighted at night.

Not only might someone fall in the dark, but the dark walkway could prove attractive to a mugger or rapist. Today, you must reasonably provide for the safety and security of your tenants whether they're inside their units or walking up to an entryway from the street or a designated parking area.

Topography. I once owned a property that was sited slightly below grade. After every hard rain, water flowed into the garage as if it were transported there by an aqueduct. In addition to drainage, topography will affect the slope of the entranceway to the property. Even moderate inclines can make navigation up or down difficult during snow and ice storms. Topography also can increase renovation costs and expose a site to greater risk from mudslide or earthquake.

Egress and ingress. Apart from navigating driveways covered by ice and snow, does the property's site produce any other problems for residents as they pull in and out of the property? Traffic? Does

the building itself block a view of whether cars are oncoming. Even relatively slight difficulties of egress and ingress can deter people from renting units in a building—or create irksome feelings among those who do.

Name Your Building

One of the best ways to create publicity for your building is to name it. When your tenants tell friends and acquaintances where they live, they won't say 2100 4th Avenue. They'll say, "At Lemon Tree over on 4th Avenue." "Oh," the friend responds, "I've heard of that place. It's supposed to be a pretty good place to live. How do you like it?"

"It's great. We pay a pretty stiff rent, but it's well worth it. Certainly beats most of those rat traps we looked at. The owner really works to make sure everything's taken care of."

2100 4th Avenue, Hampton Arms, or The Lemon Tree? Names make a difference.

Turnaround Name Change Do you recall the airline Value Jet? If so, you may remember the company because of its lax safety standards. They flew one of their planes into the Everglades and killed everyone on board. Because Value Jet no longer operates, you may think that the bad publicity surrounding that accident drove the company out of business. But it didn't. Value Jet now flies under the name Air Tran.

Take a tip from Value Jet. If the building that you're buying suffers a poor reputation, dump its present name and give it a new one.

What Name Should You Use? Match the name of the property to a theme you carry through in your marketing, landscaping, and building design. Use a name that will appeal to your target market. Avoid names that have become shopworn or clichés. Pick up a newspaper from a large city across the country. Read through

the names of the new home developments and large apartment complexes. Find a distinctive and appealing name that you can adapt to your operations.

If your property is old, it may carry a moniker such as "Hampton Arms" or "Mayfair Apartments." These names date the property. Unless you're appealing to seniors, get rid of any name that sounds like it came from the 1940s—unless, of course, you can creatively develop a period theme that combines clever nostalgia with hip. (How about Casablanca with a film noir motif?) Stand out in the crowded marketplace. Your choice of names and an overall theme for the property can work magic. (See Figure 9.1.)

Tenants pay for a higher status address.

Ask the Post Office to Place Your Property in a More Prestigious Location No, the post office won't move your building. Sometimes, though, they will give you a new address, as when a small portion of Miami decided they wanted to name themselves Pinecrest, and Gaithersburg, Maryland, was able to change its name to North Potomac to share the aura of its prestigious neighbor. Building names and addresses count. So much so in some areas that buildings on one less prestigious street will connive to secure the address of another more prestigious street.

The owner of 466 Lexington in Manhattan connected his building to the property at 230 Park Avenue, and thereby became (with the blessing of the post office) 237 Park Avenue. Just by finagling a Park Avenue address, this owner managed a 10 to 20 percent increase in his rent collections. Figure a way to obtain a higher status address, and tenants will pay higher rents—even though nothing else about the property changes. In some cities, tenants pay more for the right zip code or telephone exchange, especially now with the proliferation of multiple urban area codes.

One of my earliest large properties was a campus complex of 130 units. When I took it over, only 20 units were rented for the next semester! The problem stemmed largely from location. The project was on the outskirts of the campus area, definitely farther from classes than most housing. Because it was across a bridge from campus, it was psychologically separated as well as geographically.

Because the project had a very low occupancy from its inception, it had suffered from poor maintenance and developed a shoddy, second-class image.

I knew I would have to upgrade the physical condition of the property immediately, but my main concern was how to change the total image. I had to make the property desirable as a place for students to live. Because I could not move the building, I had to make it inviting in its present location.

To quickly create a new and exciting image, I started with a new name, "Campus Highlands," and a symbol in the form of "Scotty," a Scottish Highlander, complete with kilt.

This gave quick visual identification to everything I did in the way of promotion and advertising, and one move just built on another.

No doubt the major marketing coup was the introduction of a minibus suitably identified with Scotty and available for the exclusive use of Highland residents. A driver ran tenants back and forth to school all day, and on weekends we made the rounds of campus bars, hangouts, and athletic events. Now I could advertise as the only apartments that were just a few steps away from every place on campus. In nothing flat, the location problem was not only neutralized, it was turned into a plus!

To get inexpensive attention and build our name, I printed up thousands of miniature bumper stickers featuring "Scotty sez . . . " followed by some risqué remark. It was kind of a student-oriented fortune cookie campaign. Everyone was anxious to read everyone else's "Scotty sez" sticker. They quickly appeared on bicycles, raincoats, notebooks, and throughout the college. Since everyone was asking who Scotty was, the entire student body soon knew about Campus Highlands.

Now that I was getting tenants, I added an amenity that fit their idea of fun. "Scotty's Club" was set up for the residents in an unused basement space as a lounge-recreation area. On Sunday evenings the management threw free beer and pizza parties with special events such as W. C. Fields movies. Pretty soon Scotty's Club was the "in" place on campus. After just one semester, the Highlands was the only apartment complex on campus with a waiting list.

(continued)

Figure 9.1 Investor Craig Hall Tells How He Repositioned Campus Highlands.

Although this was a very special situation, it is a universal example because it dramatically illustrates the most basic of all marketing principles: Relate to the needs and desires of your market. Don't look for ideas that will work in all properties—there are none. Keep an open, searching mind. Seek out things you can do to attract and satisfy the best tenants for each specific investment. Then do those things necessary to get them and keep them.

Figure 9.1 (*Continued*)

Signage

Place a sign on your property.[1] Not just any sign, but a sign that conveys the character, quality, and distinctiveness of the property. Generally, use professionally designed signs of attractive wood at least 4' × 6' in size. Place the sign in a bed of flowers, plants, or shrubs, and highlight it at night with an energy-efficient flood lamp. Your sign and lighting will make the building easier to find by the guests of your tenants and your prospective tenants. The attractiveness of the sign when combined with your landscaping and the exterior of the building further publicizes the quality of your property.

Curb Appeal: Summing Up

As a buyer-fixer, I love to find good apartment buildings with run-down exteriors, yards, landscaping, and fencing. Taken together, these deteriorated features lock a negative impression into the minds of most investors. These negatives heavily discount the property's curb appeal and its market (and rental) value. Among all of the improvements you can make to a property, dazzling curb (and backyard) appeal will pay back your costs many times over.

[1]Before you design signage, verify the requirements and prohibitions of local sign ordinances. Nearly all cities regulate sign size, placement, and lighting.

Which will you distinctly recall: the Armani suit or the stain on the Versace tie?

The Well-Dressed Man or Woman Think of the well-dressed man or woman. Both achieve that spectacular look by attending to a dozen or more details. Hair, makeup, jewelry, color, style, fit, freshly cleaned and pressed—everything works together. Now, place a stain on a blouse or tie and what do you get? A negative impression. That's what people remember.

How to Achieve Dazzling Curb Appeal Unless you're creatively gifted, *great* ideas for improving a property may not come to you easily. They certainly don't come easily to me. I rank high among the artistically challenged. So, here's how I overcame this obstacle.

I carry a camera in the glovebox of my car. Often when I see a building or yard that displays eye-catching features, I snap a picture. Over time, I've put together a large collection of photos. When I'm trying to figure out how to best improve a fixer property and give it curb appeal, I pull out some of these photos and compare a model property's feature to a feature of the fixer property. This method always brings forth a rush of value-creating ideas. Try it, you'll like it.

I'll remind you that you need not rely on your own snapshots. Dozens of *House & Home* and *Apartment Living* types of books and magazines fill the shelves of bookstores. I buy these publications. Their articles and photos definitely juice up my creative thinking and aesthetic sensibilities—as they will yours.

List ways to generate extra income.

Collect More than Rent

When you review the income statements of apartment buildings, you will frequently come across a line item called "other income." These amounts may include money earned from

laundry machines, parking, storage lockers, and various services and amenities.

Laundry

Ideally, your units will include washer/dryer hookups. But if they don't, look for space somewhere on the property to put coin-operated (now card-operated) washers and dryers. Without on-premises laundry facilities, your building will suffer a competitive disadvantage. Most good tenants were raised in homes with a washer and dryer. They do not want to start taking their dirty clothes to a laundromat.

Forget about machine maintenance problems. Many owners of investment properties don't own the building's washers and dryers. They contract out the business to companies who split their take with the real estate investor. You can also lease machines with a maintenance agreement. Then all net receipts from the operation of the equipment belong to you. Price both alternatives to see which one proves most profitable in the type of building(s) that you own.

Parking

If parking is scarce in the neighborhood where you own properties, consider an extra charge for parking (or perhaps an extra charge for a second car). Do not arbitrarily give one or two parking spaces per unit. Some tenants may not own cars. Others will park on the street when you price your scarce parking separately from the apartment units. Those tenants who value it most will pay more.

As with other decisions, vary your parking policy relative to the practices of competing properties and your total value proposition. Nevertheless, think through your possibilities. Assigning a space with each unit is one possibility. But explore other options that place the highest value on a scarce resource.

Calculate the value of your parking facilities.

If your site is blessed with more parking spaces than are needed by your tenants, rent those extra spaces to tenants who live in nearby buildings that lack adequate parking. Some car owners will pay extra for covered parking. If your property will accommodate this improvement, the payback often creates a sizeable return on investment.

Build Storage Lockers

Squeeze some profitable use out of every nook and cranny within the building and within every square foot of the site. Make all space usable space.

One such profitable use is storage lockers. Does the property include an attic, basement, underutilized outbuildings, or crawl spaces where you could carve out room for storage? You can rent lockers for $25 a month or more. Lockers often achieve payback in less than four years. If no existing space within the building can serve this purpose, perhaps the site might accommodate several of those prefabricated storage huts.

(*Note:* Before you convert any space into paid storage, determine whether you might convert it into livable rentable space. If so, run the numbers to figure which use could generate the highest amount of net income. Surprisingly, paid storage often provides the more profitable use.)

Cable/Satellite

As the owner of a multi-unit building, you might be able to control access to the individual apartments by the cable and satellite telecoms.[2] Such control could add to your rental income in three ways.

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[2]Check with a local attorney. Owing to political lobbying by the cable companies, federal regulators are challenging the rights of property owners to exercise control over their own buildings.

1. *Buy wholesale, sell retail.* Wire the total building and pay the provider a wholesale cost; then charge each tenant a monthly rate with a markup.
2. *Buy wholesale, sell wholesale.* Pass along your wholesale cost savings to your tenants to bolster your competitive edge. This good deal will stick in their minds.
3. *Buy wholesale, include the service with the rent.* I do not usually advocate any approach to revenue whereby a special service or amenity is offered to everyone, unless the marginal cost of providing the service is low and few residents would pay for it. In most instances, you gain by selling to those who value and appreciate (no extortion) what you're offering. *Free* seldom pays as a market strategy. Nevertheless, if competitive conditions warrant, add this perk.

Again, the cable/satellite potential illustrates how entrepreneurial property owners persistently question standard operating procedure. They persistently evaluate what is and contemplate what could be.

Add Other Amenities or Services

As he reveals in Figure 9.1, noted real estate syndicator and turnaround specialist Craig Hall bought an underperforming property that suffered because of its inconvenient location. As part of his strategy to create value, he offered tenants a commuter van. Likewise, when you manage a property, list services or amenities that you could provide (preferably at a price) that would increase your revenue *and* strengthen your competitive edge.

In addition to cable/satellite, could services such as cleaning, day care, or transportation work? In terms of amenities, would your tenants appreciate (and pay for) a swimming pool, tennis courts, racquetball (or squash) courts, a fitness center, or a study room? As Craig Hall advises, "Keep an open and searching mind. Seek to offer benefits that attract and satisfy the best tenants for each specific investment property." Amen!

CHAPTER 10

More Creative Ways to Make Money

You've discovered how to choose an area with a stable (and preferably) growing economy, value a property, and fashion your entrepreneurial improvements toward a selected target market of tenants. But your opportunities to make money with investment properties extend much farther. You can also incorporate one or more of the following ideas to enhance your rental revenues and profits:

- Tailor your lease agreement.
- Offer units with furnishings.
- Improve the neighborhood.

Tailor Your Lease Agreements

Use your lease to reinforce your market strategy.

Most owners of investment properties draft their leases to set forth ironclad terms that require tenants to pay rent, care for the property, and follow house rules and policies. As a result, such owners never realize that the lease itself can become a powerful part of their overall market strategy.

In fact, leases can do more to advance your market strategy than they can to force a bad tenant to go straight. You primarily deal with bad tenants through careful screening, not by going to court to enforce a lease.

True, in these litigious times of tenant rights, you must bind your tenants with a well-crafted and legally enforceable written agreement. However, go beyond legal necessity. Consider how to use the language of your lease to attract great tenants.

Competitive Advantage

Before you choose specific clauses for your lease, review the leases of other property owners. Differentiate your rental agreement in ways that would encourage tenants (your target market) to choose your property over competing properties. For example, would you gain competitive advantage if you lowered your up-front, move-in cash requirements, offered a repair guarantee, shortened your lease term, guaranteed a lease renewal without an increase in rent, or placed tenant security deposits and last month's rent in the investment of the tenant's choice to accrue interest or appreciation for the tenant's benefit?

Your lease helps to differentiate your properties from those of your competitors.

Or maybe you could develop tight or restrictive lease clauses and position your property as "homes" for more discriminating and responsible tenants. You could include severe restrictions on noise and other nuisances common to apartments. Promote your property as "the quiet place to live."

You create competitive advantage not only by adapting the features of your property to the wants of your tenant market but also by custom tailoring the clauses, language, and length of your lease to match tenant needs.

Explain Your Advantages By drafting leases to better fit the preferences of your target market, you can increase your rental

Show and tell.

revenues, achieve a higher rate of occupancy, and lower your operating expenses. To realize these benefits, though, make sure that prospective tenants recognize and understand the advantages you offer. Adopt the strategy of a sales pro. Rather than rotely show a property, explain (from the tenants' standpoint) the desirable features of both the unit and your lease.

Understandable, Easy-to-Read Language As a starting point, consider doing away with those multipage, fine-print lease forms that are filled margin to margin with legal jargon. Instead, work with an attorney to construct a reader-friendly agreement. Besides, excessive legalisms often work to your disadvantage.

What good is a lease that no one can or will read?

Legalisms bite back. When you adopt a purely legalistic approach with your tenants, don't be surprised when they respond in kind. The more pages your lease entails and the more arcane its language, the more likely that your tenants (or *their* lawyers) will find some word or clause to argue about. (Lawyers pull in more money from litigating a lease than they do from drafting a lease.)

In times past, owners used fine-print leases to intimidate tenants. Today, that purpose is as outdated as feudalism. If pushed today, tenants and their lawyers can become equally combative in their interpretation of lease clauses. Even worse, your tax dollars may actually pay your tenant's attorney via legal aid or government tenant rights agencies.

Bad tenants break strong leases every day.

The myth of a strong lease. Supposedly, a *strong* fine-print lease is one where every clause binds the tenants into doing exactly what you want them to do. (If it were only that easy!) Often, though, tenants do what they want to do—lease or no lease. Don't believe in the myth of a "strong" or "airtight" lease. In most cases,

it's not the strength of the lease that determines whether your tenants conduct themselves in a manner consistent with your wishes. Rather, it's the quality of the tenants themselves.

Strong leases never substitute for careful tenant selection. When push comes to shove, a strong lease *may* help you mitigate the aggravation and losses caused by troublesome tenants. But, regardless of the language in your lease, it's good tenants alone who will make your days as a property owner profitable and enjoyable.

Joint responsibilities? Because ostensibly, most leases are drafted for the primary benefit of property owners, they routinely slight tenant rights and owner responsibilities. As part of your market strategy to attract quality tenants, your lease might display more balanced treatment.

Many tenants do distrust landlords. If you adopt a just approach, you display good faith. It also reveals you to be a cut above other property owners. Because you do intend to fulfill your responsibilities, a listing of these responsibilities will help educate your tenants. Many tenants believe that owners of rental properties do little more than collect rents and get rich. You gain when you disabuse them of this illusion. List your responsibilities within the lease.

Ask tenants for their input.

Joint drafting? People feel more committed to agreements when they help shape them. To use this fact to your advantage, discuss and draft the terms of your lease agreement with tenant participation. Naturally, you'll have a good idea of which clauses, conditions, and responsibilities you want to address. But some give and take will make tenants feel like contributing partners rather than serfs.

Win-win negotiating. Joint drafting provides another benefit. Your proposed tenant may suggest trade-offs whereby you both win. Some years back when I first moved to Florida, I tried to rent

a place to live for a period of three to six months. Before buying a house, I wanted time to learn the market and explore options. But because I desired a short-term tenancy as well as the fact that I owned a Yorkshire Terrier, I faced slim and undesirable pickings. As a result, I stayed at a Holiday Inn for 14 weeks.

Yet, had I been able to secure a satisfactory rental house or apartment, I would have been a perfect tenant who was willing to pay a premium rent and large security deposit. Yet, all of the property owners and managers I talked with simply stated their no pets and/or one-year rental requirements. None even hinted at the possibility of negotiating win-win.

You can boost profits with a flexible, open mind.

Before you adopt a rigid policy, think. Even if you don't jointly draft a lease agreement, keep the negotiating door open. Let the prospective tenants know that you are open to win-win flexibility and mutually advantageous changes. When you ask for tenant input, you discover the issues of most concern and value to the tenant. It's those instances that you can price for maximum profit, yet still offer tenants their preferred value proposition (PVP).

What Terms Might You Negotiate?

Theoretically, you could open up the entire lease to negotiation. That's the practice for leases that apply to many office buildings and shopping centers. But excessive flexibility can prove unworkable. In my experience, here are several issues where you might voice flexibility.

- Screening criteria
- Amount of rent
- Amount of deposit
- Improvements for tenants
- Pets
- Wear and tear
- Terms of the lease
- Strict rules

As you negotiate, remember that your negotiations must fit within any applicable fair housing laws. In the United States, you can't vary the terms of a lease because of a person's race, religion, ethnicity, sex, age, disability, or any category that's protected by federal, state, or municipal housing laws.

However, fair housing doesn't deny you the right to mutually tailor a lease with your prospective tenants. As analogy, mortgage lenders discriminate and negotiate mortgage terms and costs every day of the week. They may not, though, discriminate on nonpermissible grounds. Neither should you.

Don't arbitrarily screen out good people.

Tenant Screening Many property owners set one minimum standard for credit and income. Applicants either pass or fail. This screening policy will generally prove simple and legally defensible. Mortgage applicants don't suffer the same fate. Whereas years ago borrowers were either accepted or rejected, today lenders quote different interest rates, down payments, and closing costs to hopeful borrowers who differ in terms of credit quality, affordability ratios, and job history. Contrary to popular belief, most lenders negotiate loan costs.

In other words, if you have earned a FICO (overall credit profile) score of 780, nearly all lenders will charge you less and approve you for a lower down payment than someone who has a 620 FICO score. Would this same policy work for your rental applicants?

Good people, bad credit. Say you ask $750 a month and require a $1,000 security deposit. You receive an application from a couple whose credit score of 575 sits below your cutoff number of 625. They explain that their bad credit resulted from a spell of unemployment. They always paid their rent on time. They really like your unit. They're willing to pay $800 a month and give you a $2,000 security deposit.

What do you do? Do you accept or reject them? Some owners would never get this far. Their rigid minimum would rule this couple out. But it's for this very reason that you might want to set a policy of flexibility—as long as you're compensated accordingly.

Amount of Rent Some owners prefer not to quote a rental rate over the telephone. Instead, they quote a price range. When prospective tenants show up to look at the apartment, the owner asks, "Okay, what will you give me for it?" Well, he doesn't use quite those words, but words similar to those do set the stage for discussions about the amount of rent that the prospects would willingly pay. This approach can prove profitable for at least two reasons:

Find the high bidder. You might get a high bid from someone who particularly likes your unit because it offers one or more critically important features that the prospect has not found elsewhere. That's why you gather market research. Discover and incorporate these features into your market strategy such that you can charge higher rents, yet provide more tenant satisfaction. When tenants bid, you could end up with a higher rental amount than you would have thought to ask.

Twenty phone calls? Fifteen applications? Raise your rents.

More owners should use bidding when tight markets or their superior properties yield a battalion of applicants. In these situations, owners typically accept "the best qualified." But rather than pick and choose from among a number of candidates, let each prospect bid. The unit will go to the persons who value it most highly. In hot housing markets, home sellers use the bid process to sell for amounts that climb above their asking prices.

Learn market information. Price your units according to bid, and you gain valuable market information. Think back to our discussion about those owners who brag, "We never suffer a vacancy. Our apartments always rent the first day they hit the market." In fact, any owner who makes this claim is really admitting, "We don't know

Bids beat test marketing.

how much tenants would pay for our units. But we do know that we're under the market."

Other owners take a market savvy approach. A unit comes on the market, they advertise it at $650, and it rents the first day. Three weeks later, a similar unit becomes available. The owners advertise it at $675. It rents the first day. One month later, another unit comes on the market. They ask $750. No takers after two weeks. They back off to $715, and the unit rents in three days.

The trial-and-error approach works better than continual error without trial. Nevertheless, had these owners run an auction or other type of bid procedure, they would have learned early on that the market had jumped substantially ahead of where they thought it was.

Bids help weather soft markets with minimum loss.

Gain in down markets, too. Bids also yield market information on the downside. If you show a unit to 12 prospects over a period of three weeks and get no takers, your rent is too high (or you're marketing the wrong product to the wrong people). When markets soften, the faster you learn that fact, the quicker you can adjust your market strategy. Don't merely complain that your vacancies are caused by a glut of new apartment complexes offering two months free rent. Revise your rents, lease terms, or property features to reestablish a competitive advantage.

Security Deposit Vary the amount of your security deposit based on the credit score of the applicant. Or instead of a cash deposit, you could accept a lien against the tenant's car or another type of asset. You might waive (or reduce) the deposit if the prospects will get someone with a strong financial profile to guarantee the lease. (Mortgage lenders use these techniques to make loans to borrowers who otherwise would not qualify on their own.)

Especially in soft markets, qualify prospects without jeopardizing property profitability. Think of credit card companies that

Structure your screening standards to accept as well as turn down.

have figured out ways to qualify the unqualified. Or imagine what type of slump the auto industry would face if dealers only sold new cars and trucks to people who could afford them.

Want to bring in more income? Avoid rigid standards. Think of alternative ways to ameliorate risk. Look for ways to accept, not reject.

Improvements for Tenants You're talking with a prospect who sits on the fence of indecision. You want to persuade her to sign up for your unit. You ask, "What is it that you don't like about the apartment? What can I do to encourage you to make our building your home? Are you thinking of some changes that would better suit your preferences or needs?"

Again, this conversation will reaffirm that you're open and flexible and would like to please the building's residents. Also, when you candidly talk with prospective tenants, they provide good ideas that you can put to strategic advantage throughout your operations.

"Yes, I believe that if you moved the refrigerator over here, that would make the kitchen easier to work in. Then you could put in a pass-through for the dining room. And why don't you hang a microwave under the cabinet over here?"

"Great ideas. I'll get these things done tomorrow. We're proud that you've chosen one of our rental homes, and we know you're going to love residing here."

Pets Tenants pay substantial rent premiums for the privilege to keep a small pet in their apartment. The problem for property owners, however, is not so much pet damage to their property (which can be covered by a large security deposit). Rather, misbehaving pets (and pet owners) annoy other tenants.

No one wants to hear a dog yelping all day because it is left alone in the apartment. No one wants to hear a cat fight at 2:00 A.M.

Pet policies bring in more revenue and may create more problems.

So, your mission, should you choose to accept it, is to figure out a way to capture the extra revenue that pet owners are willing to pay. Yet, do so with an absolute tenant guarantee that their pets will not disrupt the peace, quiet, and cleanliness of the premises. If you can negotiate an agreement that satisfies these objectives, you will earn the King Solomon award for shrewd wisdom. (I regret that on this point I cannot suggest any uniform principles to guide you.)

Wear and Tear So-called standard leases often state that tenants are responsible for all damages *except* normal wear and tear. I do not use such a clause. It invites tenant neglect and abuse. Some tenants believe that soiled carpets, cracked plaster, broken screens, and other damages reflect nothing more than normal wear and tear.

I disagree. If a tenant properly cares for a property, that property will not suffer any noticeable wear and tear during a tenancy of one year or less. For such short-term periods of residency, tenants should leave the property in essentially the same condition in which they accepted it. Eliminating the wear and tear clause will save you money and argument.

If prospects don't accept this condition, I ask them what wear and tear damage they expect to do to the property throughout the year. Because they won't admit to causing damage, that usually settles the discussion. If they do come back with a response that will create wear and tear, I negotiate for more rent, a higher deposit, or some other tradeoff. In the end, I don't take a hard line, but I do want prospects to understand that my rental rates do not include an allowance for damages—wear and tear or otherwise.

Tenants on one-year leases should not create wear and tear.

Terms of the Lease Do not reflexively set the term of your leases at one year. Many good tenants need a place to live for a

shorter period of time and will pay a premium for that opportunity. You might even coordinate a weak and peak type of timing. Say you get a vacancy in the slow season. If you leased for a year, you would face a vacancy again next year during the slow season.

Instead, offer a six-month lease until the peak season; or perhaps a lease for 18 months. I know an owner of a 12-unit property in Flagstaff, Arizona, who rents his units on nine-month leases for college students (September through May). During the summer tourist season, he accepts 30- to 90-day rentals at inflated prices (yet still priced less than the rates charged by name-brand motels and hotels—and also less than time-shares).

Strict Rules Property owners frequently misunderstand the prime purpose of rules that govern tenant behavior. These owners think that rules exist primarily to protect their property. Not true. Look at the long and detailed house rules that govern the homeowners of a $2 million Manhattan co-op or a $2.5 million Longboat Key condominium. These rules exist to preserve the nature of the community. The residents impose and enforce strict rules on themselves.

Give the tenants a voice in rule making.

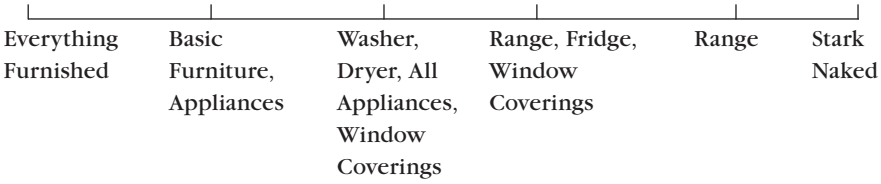
The same principle holds for apartment communities. Make strict rules part of your market strategy. The best tenants are those who appreciate tight rules that control pets, noise, parking, smoking, cleanliness, partying, and so on. You don't use your rules to control behavior per se. Rather by adopting strict rules, you appeal to people who conscientiously behave as good citizens and want others to behave likewise.

Structure your rules for the good of the residents, not as some punitive dictate of a feudal landlord. Seek input from tenants as to what rules they would like to see implemented, modified, or discontinued. It's your building, but it's their home. Give them a voice in how you can enhance their satisfaction and everyday living.

Summing Up I have sampled a variety of ways that you can incorporate screening criteria, the terms of a lease, and various house rules into your market strategy. Many owners of investment properties never realize how these legal or financial issues tie in with marketing an apartment building. But now, you see why you should never adopt a leasing procedure without weighing its costs and its benefits. Use the terms of your lease to target market in the same way that you can design the features of your property to appeal to a select segment of residents.

Should You Furnish Your Apartments?

Some owners offer their apartments with everything furnished including dinnerware and bedclothes. Others rent their units stark naked—not even appliances or window coverings. Most owners operate somewhere in between these two extremes.



Add appliances and furniture to jump your rent levels and reduce vacancies.

Where along this continuum should you operate? By now, you know the answer to that question. It depends on whom you are targeting with your units. It depends on the overall balance (or imbalance) in the supply/demand ratios for these various possibilities. The key to maximum profitability lies in figuring out how much payback you will get as you incrementally add appliances and furnishings.

All Price Levels

Although *furnished* implies low end, that's not necessarily the case (see Figure 10.1). In many cities, strong demand exists for furnished units from mid- to upper-income households. Most of these tenants own homes elsewhere, or they may have placed their household goods in storage. Their temporarily transient situation gives need to a shorter-term, low-hassle living arrangement. Absent a suitable house or apartment, people in this market typically reside in regular motels or extended-stay types of accommodations.

High Payback

Although niche markets vary, you generally earn a high payback for offering some furnished units. I have gained premium rents in both upscale and downscale furnished properties. Some downscale tenants even rented units for as long as five or six years.

Because furniture and appliance rental companies now proliferate, you don't see as many apartments offered furnished today as was common 20 years ago. Nevertheless, when I recently surveyed local owners of furnished properties, they reported that they faced no difficulty keeping their units rented. When I verified this information through my callback technique (mentioned in Chapter 4), I found that nearly all available units were reletting within less than a week.

On average furnished apartments lease faster, but turn over more quickly.

Even if you choose not to provide furniture, you may find (as I have) that you can enhance your units with appliances and window coverings. An attractive range, refrigerator, washer/dryer, and miniblinds can add $50 a month (or more) to your rent collections per unit. When you consider that the cost for these items will run less than $2,000, that extra $600 a year translates into a significant

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Figure 10.1 Make More Money with Furnished Apartments.

payback. Units so equipped typically rent more quickly than stark naked units.

Warning: Don't Pay a Premium Price for Furnished Apartment Buildings

When you buy an apartment building that includes furniture, appliances, or other personal (as opposed to real) property, value the real estate and personal property separately. Otherwise, you will overpay. Say that you value two identical buildings—except that Fairview Village rents furnished apartments and Tiffany Hill offers stark naked units. Fairview Village yields an NOI of $50,000 per year. Tiffany yields an NOI of $40,000. Using the cap rate valuation formula, you value the two properties as follows:

Fairview Manor

$$V = \frac{\$50{,}000\ (\text{NOI})}{.10\ (\text{R})}$$

$$V = \$500{,}000$$

Tiffany Hill

$$V = \frac{\$40{,}000\ (\text{NOI})}{.10\ (\text{R})}$$

$$V = \$400{,}000$$

Differentiate the income from real estate from the furniture.

What's wrong with this picture? You've just overvalued Fairview Village because you've attributed $10,000 of annual NOI to the real estate, whereas you should have allocated it to the furniture. You can easily go out and buy furniture and appliances, then simply move these items into the rental units. Value furniture and appliances according to their actual replacement cost less depreciation, such as the amount you would pay if you bought comparable used items from the newspaper classified ads. Value buildings furnished with personal property as follows:

NOI (stark naked) = $40,000

R = .10 (or whatever rate applies in your market)

$$\text{Value of real estate} = \frac{\$40{,}000}{.10}$$

$$V_{re} = \$400{,}000$$

Naïve investors may pay you an unwarranted premium price for a furnished apartment building.

The value of personal property (as evidenced by the used furniture and appliance market) is $25,000. Rather than pay $500,000, you should bid $400,000 + 25,000 = $425,000. Never capitalize the incremental income produced by a furnished apartment. Otherwise, you pay more than the furnishings are worth in the used furniture market. Of course, when you sell, you can try to shove all of the income you can into the NOI that you're capitalizing. Some naïve investors (as I once was) fail to discount rental income derived from from personal property.

Improve the Neighborhood

Buy in the most *profitable* neighborhood.

Nearly all so-called experts advise, "Buy in the best location you can afford; you can change everything about a property except its location." When it comes to apartment buildings, this advice fails for two important reasons.

1. *Income is higher.* Relative to their sales prices, low- to moderate-income properties typically yield higher cash flows than those properties in the better areas. For beginning investors, the less desirable neighborhoods can provide a profitable way to start an investment program.
2. *Neighborhoods can improve.* In many cities throughout the world, once-shunned neighborhoods are experiencing revitalization. Rapidly escalating prices in what were once middle-class neighborhoods are detouring tenants and homebuyers to locations they wouldn't have considered 10 or 20 years ago.

Become a Neighborhood Entrepreneur

Neighborhood improvement pays back higher dividends than property renovations.

When you help spearhead neighborhood revitalization, you boost your rents and the value of your property. In addition, you attract a higher number of rental applicants to your property, giving you a wider selection of tenants.

What can you and other concerned neighborhood property owners and residents do to promote revitalization or, even better, gentrification? Here are several ideas:

- *Organize a community action organization.* Seldom will individuals show initiative on their own if they think, "What's the use?" By forming a group, each individual acts with the knowledge that others are also joining the effort.
- *Lobby government.* Insist on trash pickup, better police protection, more emphasis on criminal prosecution and crime prevention.
- *Secure redevelopment money.* Cities, states, and federal governments pour billions of dollars every year into capital spending projects for neighborhoods (streets, sidewalks, sanitation, building demolition, parks, playgrounds, trees, landscaping). Put pressure on your elected representatives to direct some of that money to your area.
- *Upgrade the schools.* Does apathy reign? Do the kids spend more time with sports than homework? Do teachers discipline more than instruct? Do kids learn more on the street corners than they do in the classroom? Then crank up the volume of protest. Work with parents, teachers, administrators, police, and the kids. Push for a voucher program and enforceable performance standards.
- *Property owners unite.* Form a pact of mutual property improvements. You'll be surprised. After fix-up work begins, it becomes contagious. Personal standards of property upkeep and individual behavior are lifted.

- *Bring in the code enforcers.* Read through your city's zoning ordinances, building codes, and sanitation laws. When property owners (or their tenants) fail to voluntarily comply, insist that the code enforcers do their duty. As you read through the codes, you will find rules and restrictions that outlaw nearly all types of nuisances from junk cars to old refrigerators sitting on front porches to loud cars, blaring televisions, and unruly domestic quarrels.

The Huge Payback

Neighborhood improvement boosts rents and lowers cap rates.

Most fix-up books written for real estate investors urge owners to create value by improving their properties. I endorse this idea. But your huge payback occurs when you improve the property *and* the neighborhood.

Say you improve your property and boost your monthly rents by $100 per unit. The market cap rate for similar income properties located in this somewhat down and out neighborhood is 12 percent. After fix-up, your building increases in value by $10,000 per unit.

$$V_{pu.} = \frac{\$1,200}{.12}$$

$$V_{pu.} = \$10,000$$

Now assume that you combine property fix-up with neighborhood revitalization. Your rents go up by $200 per month; but you add still another kicker to the value equation. As neighborhoods increase in desirability (and decline in risk), the market cap rate for the area falls. With renewed popularity, the cap rate drops to 10 percent (.10). With gentrification, the rents could increase by $300 per month and the cap rate might fall to 8.5 (.085) or lower.

Revitalization

$$V_{pu.} = \frac{\$200 \times 12}{.10}$$

$$V_{pu.} = \$24{,}000$$

Gentrification

$$V_{pu.} = \frac{\$300 \times 12}{.085}$$

$$V_{pu.} = \$42{,}353$$

Look for a Starbucks to help lead you into neighborhoods poised for gentrification.

To maximize returns, buy in those neighborhoods that are poised to climb the status ladder. (For more on property and neighborhood revitalization, see Gary W. Eldred, *Make Money with Flippers, Fixers, and Renovations*, 2nd ed., Wiley, 2008.)

CONCLUSION

Investing in Action: The Bayside Apartments

Figure C.1 displays a fact sheet for a 19-unit apartment building that was listed for sale near Tampa, Florida. This miniprospectus shows potential investors many of the valuation measures that you've learned throughout this book:

- GRM
- Net operating income
- Cap rate
- Cash-on-cash return
- Price per unit
- Price per square foot
- Expenses per unit
- Expenses per square foot

When a sales agent or seller hands you a comparable fact sheet (or more extensive property prospectus), work through the numbers, compare them to other properties that have recently sold, and judge whether that seller has priced his property competitively. If the numbers invite further inquiry:

1. Perform a due diligence inspection to determine exactly what you're buying.
2. Perform an entrepreneurial analysis to weigh possibilities to enhance NOI and add value.

INVESTMENT SUMMARY[1]

			Current	*Pro Forma*
Price	$600,000			
Down Payment	$120,000	Cap Rate	11.0	9.5
Price per Unit	$ 31,579	GRM	5.1	4.8
Price per Sq. Ft.	$ 77.92	Cash On Cash	14.7	7.3
Net Rentable Sq. Ft.	7,700	Approx. Year Built	1923	

DESCRIPTION

Property: The Bayside Apartments are being sold with the adjacent property, the Bayview Apartments. The Bayside Apartments consist of two buildings of frame construction and were built in 1923. The front building unit mix is 8 two-room efficiencies of +/−400 square feet and 10 one-bedroom one-bath units of +/−450 square feet. The back building is a two bedroom cottage of +/−600 square feet. There is parking for six cars off street; all other parking is on street. **The lot is .23 acres in size and measures approximately 50 feet wide by 200 feet deep.**

Location: The subject property is located at the southern end of Pinellas County, Florida, which is across the bay from Tampa. The city has a population of approximately 245,000 people, making it the fourth-largest city in Florida. The property is in the city at 25th Street and 132nd Avenue and is within blocks of Tampa Bay. **The city, especially the downtown area, is currently undergoing a tremendous amount of growth and revitalization since the Baywalk Center has opened. There are three recently completed condominium projects with prices from $300,000 up to over $1,000,000 that have been well received.**

FINANCING SUMMARY

Proposed New Financing: $480,000

8% Interest: 10 Year Term: 20 Year Amortization

Monthly P&I: $4,014.91

[1] This information has been secured from sources we believe to be reliable, but we make no representations or warranties, expressed or implied, as to the accuracy of the information. References to square footage or age are approximate. Buyer must verify the information and bears all risk for any inaccuracies.

(continued)

Figure C.1 19-Unit Bayside Apartments.

OPERATING DATA

UNIT MIX

No. of Units	*Bdr/Baths*	*Sq.Ft./Unit*	*Current Rent*	*Pro Forma Rent*
10	1 Bdr 1 Bath	400	$475–$565	$525–$590
8	Efficiency	400	$420–$545	$505–$570
1		500	$490	$500

INCOME		**Current Rent**		**Pro Forma**
Scheduled Rent Income		**$114,936**		**$123,012**
Other Income		2,580		2,580
Scheduled Gross Income		**117,516**		**125,592**
Less: Vacancy/Other Deductions	1.0%	$1,149	5.0%	$6,151
Effective Gross Income		**116,367**		**119,441**
Less: Operating Expenses	43.4%	$50,544	52.4%	$62,544
Net Operating Income		**65,823**		**56,897**
Debt Service		48,179		48,179
Pre tax Cash Flow	**14.7%**	**$17,644**	**7.3%**	**$8,718**
Principal Reduction	8.5%	$10,146	8.5%	$10,146
Total Return Before Taxes	**23.2%**	**$27,790**	**15.7%**	**$18,864**
OPERATING EXPENSES				
Taxes		$ 4,980		$11,730
Insurance		3,300		5,700
Utilities		16,278		16,278
Maintenance & Repairs		10,197		10,197
Advertising Promotions		1,441		1,441
Reserves & Replacements				2,850
Licensing & Fees		385		385
General Maintenance & Labor		8,945		8,945
Management		5,018		5,018
Total Operating Expenses	**43.4%**	**$50,544**	**52.4%**	**$62,544**
Expenses per Unit:		$2,660		$3,292
Expenses per Sq. Ft.:		$6.56		$8.12

Figure C.1 *(Continued)*

Due Diligence Notice the fact sheet footnote that all sales agents (and most sellers) attach to their property brochures:

> We believe [the information] to be reliable, but we make no representations or warranties, expressed or implied, as to the accuracy of the information. . . . Buyer must verify the information and bears all risk for any inaccuracies.

Verify all sales agent and seller-provided information.

Although this disclaimer does not relieve the agent or seller of all legal responsibility for accurate and truthful disclosure, it does paint a large gray area. You never know how a judge (or jury) might rule. You say, "They misled me about their revenues and expenses." They reply, "No, we didn't. We told him not to accept our figures. We emphasized the fact that our information might err."

Signed Representations Some sophisticated investors shift the responsibilities for truthful disclosures back to the sellers through seller-signed representations. If the seller says, "The building's in near perfect condition. We've never discovered any problem with termites, mold, asbestos, or lead paint. Our occupancy rate has never fallen below 97 percent. This place practically rents itself. It's a real money maker."

You respond, "Great! I'm glad to learn that. By the way, you wouldn't mind putting those statements in writing and signing off on them, would you?"

I'm simplifying, of course. In such instances, usually lawyers go back and forth drafting the specific language of any signed seller representations. And you can bet that the signed statements tone down the promotional puff commonly voiced by sellers and agents.

Verify, Verify Nevertheless, even when you persuade the seller to confirm representations in writing, verify every fact that's material to your decision. To recap earlier chapters, as a minimum you must check:

- Rent roll and leases
- Physical condition of the buildings (functional, physical, aesthetics)
- Square footage of building (usable, rentable, gross)
- Quality of the site
- Site size, dimensions, boundaries
- Site amenities
- Zoning compliance
- Market sales prices and cap rates
- Market rent ranges
- Quality and intensity of competition
- Target market potential
- The local economic base
- Neighborhood features (positives and negatives)
- Code compliance (health, safety, environmental, and building)

Always question closely any pro forma data.

After you complete your due diligence, you benchmark the value of the property according to your analysis of its current operating performance. You then persuade the seller to accept *a price no higher than that performance justifies.*

Run the Numbers For the Bayside Apartments, you can see from Figure C.1 that the seller has priced this property using pro forma rents. The income statement shows that the expenses for property taxes and insurance are scheduled for a big boost next year. To make the net operating income look better than it otherwise would, they assume that the investor who buys this property will raise rents by about 7 percent. To their credit, they admit that higher rents create higher vacancy. As a result, that 7 percent rent increase only adds $3,004 to net operating income.

In other words, if you assume no boost in rents *and* a $12,000 increase in expenses, the cap rate at the asking price equals 8.98

percent (.898) or right at 9 percent—which is quite good in today's market. Of course, exactly which numbers you use depends on the facts you discover during your due diligence. On the downside, for example, you could find one or more negatives such as the following:

- Market rents are softening. New large apartment complexes are conceding 2 months free rent on 12-month leases.
- The reported expenses fall well short of the expenses actually incurred for this type of property. Property shows extensive deferred maintenance.
- Unemployment in the local economy has recently risen from 4.0 to 6.1 percent.
- A nearby company that employs 4,000 people has announced plans to close down and relocate to Mexico.

Or, your fact finding could discover some strong positives such as these:

- Market rents are advancing by 10 percent. Major competing buildings are taking waiting lists.
- Current management carelessly overspends for operations. You can easily find ways to economize.
- Local unemployment has recently fallen from 6.1 to 4.0 percent. Fourteen thousand new jobs were created during the past three months. Extensive growth expected during coming decade.
- A new 1.2 million-square-foot office and retail development just broke ground 1.5 miles away from the property.
- No nearby vacant land is suitable for large-scale development of condominiums or apartments.
- The city placed an 18-month moratorium on new apartment construction until city/county infrastructure improvements are completed.

The pro forma must conform to your knowledge of the market.

You can only make sense of numbers after you have put together facts about the property, the competition, the local economy, and the target market. With facts, you estimate the price range that current operations justify.

Entrepreneurial Strategy

Your due diligence prevents you from paying more for a property than its current condition and performance warrant. Your entrepreneurial analysis tells you whether you can craft a strategy that earns you serious money.

The Redevelopment Option Up until now, entrepreneurial suggestions have pointed toward improving a property (or its neighborhood). But also investigate site redevelopment. When a neighborhood moves upscale, the value of the land may overwhelm the value of the building. When site value accelerates, avoid pumping money into a building that's poised for teardown. Your profits will come from site redevelopment (or selling to a development company).

Before you improve, investigate possibilities for redevelopment.

How can you tell when an income property reaches the end of its economic life (even if physically fit)? Value the site separately.

Back to the 19-Unit Bayside Apartments To envision redevelopment potential, notice how the location of this property is changing. The area is undergoing "a tremendous amount of growth and revitalization." The sales flyer reports that (apparently) the area will support multi-unit condo prices "from $300,000 up to over $1,000,000." Compare those facts to the low-end pricing of the current 19-unit building—a mere $31,579 per unit. Plus, this

building dates back to 1923, which may signal both functional and physical obsolescence.

After envisioning neighborhood transformation, the entrepreneurial investor looks closely at site value and potential use:

- In what price range would this site sell if it were vacant?
- What per unit price did nearby condo developers pay for their sites?
- What price per square foot did nearby condo developers pay for their sites?
- How do the condo sites compare to the subject site in terms of size, features, accessibility, views, and the aesthetics of surrounding properties?
- What type of redevelopment will zoning permit? If not as favorable as it could be, can zoning be changed?
- If you could build higher stories on the site, could you give upper units views for which buyers (tenants) would pay a premium price (rent)?

Always value the land separately from the building.

If your site evaluation looks positive for future redevelopment, you should buy, hold, operate, and spend no more than absolutely necessary for property improvements. When the time is ripe, redevelop or sell. The income property provides an ideal way to invest in land without the risks and carrying costs that vacant land entails.

Real Estate Entrepreneurs Outperform All Other Investors

As a major recipient of mutual fund and stock broker advertising, the financial press echos the mantra, "Stocks outperform all other types of investments." Don't believe it.

Only Investors Perform

In the first place, investments don't perform. No investment offers a return that's independent of the investor. At a minimum, every investor decides what to buy, when to buy, and when to sell. Most people have failed to build their fortune and financial freedom with stocks because they choose the wrong stocks, buy high, and sell low.

In contrast, nearly all real estate *investors* (versus speculators) have made money because real estate (especially houses and income properties) offers a dependable and consistent source of wealth. No real estate investor wakes up each morning and flips on his computer to see if his property investments have tanked. Real estate investors don't buy and sell properties without diligent analysis of properties and their locations. For these reasons, real estate investors have outperformed the folks who buy and sell stocks for quick gain and mistakenly call it investing.

Entrepreneurial Real Estate Investors Perform Best of All

Sharpen your entrepreneurial vision. You will make money.

Passive investors in real estate outperform those investors who choose stocks, bonds, annuities, rare coins, or pork bellies. But *entrepreneurial* investors outperform everyone. Entrepreneurial investors detect emerging opportunities. They combine knowledge, effort, and imagination to create value for themselves and their customers.

As you evaluate properties, answer two questions:

- "As is," will this property make a good investment?

And more importantly,

- Can I *make* this property a superior investment?

When you answer an enthusiastic "Yes!" to both of these questions, you will make a lot of money with income properties.

I wish you the best. Should you have questions or comments about investing in real estate, please contact me through my web site, www.garyweldred.com.

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