<u>Make Money with SMALL INCOME PROPERTIES</u>
Outsmart the Competition
Discover the most Profitable Locations
Target Market your Properties
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<u>Introduction</u>: ñIt takes money to make moneyò is NOT TRUE.
With small income properties, all it takes is:

(1) Analytical abilities
(2) Entrepreneurial spirit
(3) Market savvy

> Donôt wait to buy real estate.
> Buy real estate and wait.

<u>CHAPTER #1: Profit with Income Properties</u>

> For this book, small income properties range in size from duplexes to 24 units.

<u>ADVANTAGES of Multi-unit Properties:</u>

(1) *<u>Lower cost of acquisition</u>*: Those who couldnôt afford payments on a $350K house now find they can afford a $550K 4-plex because the rent goes a long way toward PITI.

(2) *<u>Higher cash flows</u>*: Rent for single-family homes has lagged the increases in housing prices. Most new owners must have 25-to-40% down, or incur negative cash flows.

A. You can still find multi-unit properties selling for 80-to-135 times gross monthly rent. Smaller properties can yield positive cash flow with just 10-to-20% down.

B. Increasing numbers of baby-boomers will recognize the advantages of income properties. As more investors search-out multi-units, they will bid up prices. 5 years from now (absent a general economic collapse) the selling prices of small income properties will have climber significantly, and positive cash-flow will be rarer and rarer.

C. Even though cash-flow returns today donôt look as good as they did 5 or 10 years ago, they look far better today than they will 5 or 10 years into the future.

(3) *<u>Less search time</u>*: Amass a $5M-to-$10M portfolio with only 3-to-10 acquisitions.

(4) *<u>Greater ease of management</u>*: Maintaining a multi-unit property will cost more per building, but it will cost <u>less</u> in terms of dollars and time. With 12-unit and 24-unit buildings, you can employ an on-site manager to attend to day-to-day concerns. You can operate 50 units of a multi-family property as easily as 5-or-10 single family rentals.

(5) *<u>Increased tax-free trade-up potential</u>*: You must avoid paying taxes to the maximum extent of the law. A Section 1031 Exchange is generous.

A. The exchange is tax-free, if you follow the rules.
B. If held until death, the property passes to your estate tax-free.
C. You can arrange a sale later in a year when you have tax losses as an offset.
D. You can withdraw your equity with a tax-free cash-out refinance.
E. The capital gains tax may be on the way out (?).

(6) *<u>More potential for owner financing</u>*: Owners donôt volunteer it, but it is common.

(7) *<u>Enhanced possibilities for creating value</u>*: Value is directly related to net income. Anything that boosts net income will boost value. Effective management counts, too. Economies of scale come into play é less cost to repair one large roof compared to 12 individual roofs.

<u>CHAPTER #2</u>: Craft Your Entrepreneurial Strategy

Three most important words in real estate: IT ALL DEPENDS.

<u>Strategic Framework</u>:

I. Entrepreneurial Objectives: Personal
Financial

II. Setting up the Problem: Problem Statement
ID Property
ID Property Rights
Property Analysis
Geographic Analysis

III. Data Collection: **D**emand (who will buy)
Utility (what benefits provided)
Scarcity (whatôs the competition)
Transfer (how to market)

IV. Creating Value: Estimating methods (cost, comparative, income, improvements)

V. Synthesis and Interpretation of Results

VI. Execution

<u>Entrepreneurial Objectives</u>: *Know thyself*. Measure your personal and financial resources, your talents and your objectives. To succeed, you need to exercise financial discipline and responsibility.

A. What is your credit score? Go to www.myfico.com.
B. What is your net worth? What you OWN minus what you OWE.
C. How liquid are you? More cash é better able to adjust to setbacks.
D. How much residual income? The amount left over at the end of the month.
E. What are your goals? Write it down, otherwise people procrastinate.

<u>Setting up your Analysis</u>: Evaluate properties by addressing these issues:

A. <u>The physical property</u> é number and mix of rentals, square-footage, site size, types of construction/architecture, personal property
(1) Look for high demand, high rent, low vacancies
(2) Donôt trust sqft figures é measure yourself, look for *rentable* sqft.
(3) Old, large SFRs converted to multi-units generate great cash-flows.

B. <u>Property rights</u>: There will be encumbrances, like these:
(1) <u>Zoning</u> é restricts uses, heights, occupancy, lot/bldg sizes, historicity
(2) <u>Building codes</u> é enhance safety through a permitting process.
Never buy property that has unpermitted work without a substantial discount, always get permits and inspections.
(3) <u>Other</u> é Environmental laws, tenants leases, tenantôs rights, Fair Housing Laws, mortgages, easements, associations (deed restrictions), etc.

C. <u>Location</u>: Look for best economic climate and highest appreciation.
D. <u>Timing</u>: Plan an exit-strategy é buy-and-wait, or fix-and-resell.

CHAPTER #3: Where is the Local Economy Headed?

Study a cityôs economic base before investing

Learn from othersô misfortunes:

(1) Closely monitor the local economy and real estate markets where you are investing.
(2) Beware of using more leverage than is *safe*.
(3) Plan multiple strategies é boom economies can bust quickly.
(4) Donôt quit your day job prematurely.

Pay attention to these:

DEMAND:	SUPPLY:
Population growth	New construction
Employment, wealth, income	Existing homes for sale and rent
Costs of doing business	Condos for sale and rent
Quality of life	Apartment vacancy and rental levels
Community attitudes	Delinquencies
Entrepreneurial spirit	Foreclosures

Where to get the data:

Realtors	Mortgage lenders	Homebuilder associations
Utilities	Local colleges	Urban planning offices

Nuggets:

(1) Look for a core of *basic* employment, job growth é manufacturing, professional services, medical, travel/tourism, colleges, retailing, government centers, etc. Beware of anti-growth attitudes:

Local politicians develop a power-base that they don't want challenged. Citizens may want to preserve a way-of-life. Powerful owners of existing businesses may keep new industry out to avoid new bidders for the available workers.

(2) Quality of Life é QOL is *very* important. QOL attracts wealth.

People will abandon high-cost, low QOL areas in favor of locations where they would truly prefer to live. Areas with appeal to the "financially mobile" will experience high demand for residential properties … no doubts.

(3) Entrepreneurial spirit é itôs not just population numbers, itôs also *quality*. An areaôs prosperity will be determined by the drive of its people, their entrepreneurial spirit.

(4) Focus on long-term promise:

Properties across the United States (even throughout the *same* metropolitan areas) seldom increase in value at a uniform pace. The fastest appreciating properties are where growing demand pushes against constrained supply.

CHAPTER #4: **Size Up the Competition**:

Study your competitors, and then craft your strategy to outplay them.

Great majority of small income property investors rarely, if ever, conduct a competitive market analysis. Most never even solicit feedback from their tenants or rental applicants!

Conduct a Competitive Market Analysis (CMA):

A. Select the best area: You want *employment strength* and *population growth*. Yellow light: rising vacancies, rent concessions (tap the brakes). Green light: after vacancies, rent and prices ebb, then is the time to buy

Those who are willing to step in and clean-up-the-mess when others see nothing but despair will *win big*.

B. Use the power of market-information to negotiate:

(1) NEVER rely on income or expense data from the seller or his agent.

(2) REJECT the ploy of seller asking for higher price because ñyou can always raise the rentsò. Reserve the upside as a reward for *your* efforts.

C. Seek the most profitable competitive edge: Take note of every detail that prospects like or dislike. Catalogue strengths/weaknesses and advantages/disadvantages.

D. Construct accurate financial pro formas: Balance costs of improvements with extra amount tenants are willing to pay. They want the best deal for the money.

Identify the Competition: Generally, it is similarly-priced rentals in the same neighborhood. But also, home ownership é from 2000 to 2003, rental levels suffered because low interest rates enticed millions of renters into buying their own homes.

With sky-rocketing housing prices, many tenants can no longer afford to buy. Renting looks more affordable. In the next 3-5 years, rental markets will rebound, resulting in increased prices for small income properties.

What to look for: *View competing properties through the eyes of potential tenants*.

A. Location é aesthetics (noise, parking, views), school districts, property taxes (and services provided), crime rates, accessibility (public transportation), demographics.

B. Site features:

(1) Exterior é state of repair, materials, style, appearance. This is ñcurb appealò é does the property invite potential tenants to come in and take a look?

(2) Interior é people react emotionally to interiors in ways they can neither explain nor understand. Critique the emotional impact.

(3) Livability é floorplan (layout, flow, convenience, storage), utility costs and energy efficiency.

C. The rental process: Tenants are influenced by advertising, application procedures, deposits, lease terms é even personality/professionalism of managers.

Look for the competitive edge … the advantage your property has over competitors:

If very few rentals permit pets, maybe you should allow them.

If everyone requires 12-mo leases, maybe you should allow for shorter terms.

<u>CHAPTER #5</u>: Go After a Target Market

> You want to provide *value* to a select type of tenant. You want them to shout, ñWow, weôll take it! Weôll pay whatever youôre asking!ò

<u>Retrace the steps we will take</u>:

(1) Survey strength of pertinent market areas
(2) Discover all you can about competition
(3) Select a target market of renters é learn all you can about them.
(4) Buy a property that *could* be superior to the competition.
(5) Execute an improvement program for this property
(6) Develop a value-campaign to sell, trade or lease the property

<u>Craft a strategy to meet a motivating need/want/problem related to these characteristics</u>:

Age	Education	Sex	Household size/composition
Occupation	Height/weight	Income	Health/disability
Stage of life	Religion	Ethnicity	Marital status

Slice and dice the demographics in different combinations.
Pin-point the needs of a narrow type of person, family or household.

<u>Psychographics</u>: mental pre-dispositions é likes, dislikes, tastes, preferences, attitudes, values, lifestyles.

A. <u>Never rely on labels</u> é empty-nesters, 1st time buyers, trade-ups, etc. Picture in detail the characteristics of the people youôd like to impress.

B. <u>Avoid broad-brush</u> é within each category, people show critical differences.

C. <u>Identify your tenants ñhot buttonsò</u> é what things are missing at your competitionôs property? Parking? Closets? Safety and security?

D. <u>Know your customer</u> é throw out the ñstandard operating procedureò

The more closely you attend to the motivating needs of your tenants, the more they will reward you with a higher and more dependable stream of rental income.

<u>How to Identify VALUE features</u>:

A. <u>Talk informally with tenants</u>: They know what they want é so, ask them.

B. <u>Pay attention, eavesdrop, read, watch</u>: Newspapers, local journals, internet

C. <u>Talk with insiders/experts</u>: RE agents, property managers, bankers, inspectors, city planners, investors, contractors, reporters, housing administrators

D. <u>Use questionnaires</u>: for $100, you can get local college students to do it.

E. <u>Use focus groups</u>: Nearly every major home builder in the country now runs focus-groups to learn the thinking of their intended customers.

<u>Anticipate and adapt to change</u>:

A. <u>Seniors</u>: Where will 60 million new retirees on the horizon want to live? What trends can be imagined é downsizing, small towns, ground-level, mild climates

B <u>Echo-boomers</u>: Record numbers of 25 yr olds will be flooding the entry-level housing markets.

Senior and echo-boomer waves will hit full stride in the coming decade.
Find a trend and ride it to profits.

CHAPTER #6: Is the Property a Good Deal?

> A below-market purchase price may not be the best investment. Sometimes, paying above market price yields the best returns and safety.

Multiple criteria for evaluation:

(1) Replacement cost: When market values exceed replacement costs by 10-15%, thatôs a caution flag. Builders will fill the void, oversupply will result. Perfect timing for investors is to buy with market values below replacement costs (no builder competition).

With growing population, jobs, QOL and economic base, rents are guaranteed to rise. More demand pressed against fixed supply will reward investors.

(2) Per-unit measures: Never compelling on their own, these measures are meaningful benchmarks for comparisons.

Price-per-unit
Price-per-squarefoot (most widely used, but few standards for measuring sqft)
Price-per-frontfoot (good for waterfront sites)

(3) Gross Rent Multipliers: Generally, when GRMs go much above 8.0, the result is negative cash-flow é unless the downpayment is 30% or more.

(4) Capitalized Value: $$\text{Value} = \frac{\text{(net operating income)}}{\text{(capitalization rate)}} = \frac{\text{NOI*}}{\text{R**}}$$

*See the sellerôs Schedule E, where they report property income and expenses to the IRS.
** Represents your unleveraged, pre-tax annual cash return.

Cap-rates for small rental properties run from 6% to 14%, or higher. Cap-rates for real estate can be likened to P/E ratio for stocks. Cap-rate = 8.5% is like a P/E ratio = 12. Both measures try to valuate a stream of income.

Generally, a *low* cap-rate occurs with desirable properties in top neighborhoods. A *high* cap-rate is associated with less desirable properties in so-so neighborhoods.

Sellers will ask you to pay for *potential*. Investors pay only for the present, retaining the future as a bonus for entrepreneurial talent and insight.

(5) Cash-on-Cash return: $\frac{\text{(NOI ï debt service)}}{\text{(downpayment)}}$ must be greater than ñhurdle rateò

(6) Growth in Equity: In addition to annual cash-flows, your wealth grows through property appreciation and mortgage amortization é turns acorns into oak trees. Then, even *better* news: you can also increase value by improving the property!

CHAPTER #7: Collect More Rents

> Never think of yourself as a *landlord*, or ñmanager of rental propertiesò. You provide your customers with housing that stands-out compared to your competitors.

This attitude will increase profits:
(1) Better resident relations é lower turnover, fewer problems, higher rents.
(2) Vigilance é a constant-improvement mindset will add value to your property.

No matter what the sellers or their agents tell you about a property, you must conduct your own "careful, independent investigation". If you are expecting full and accurate disclosure, sorry … you are dreaming.

A. Verify rent collections é 95% occupancy does not mean 95% rent collection!
  (1) Examine all leases and rental applications
  (2) Talk w/tenants ... Problems? Hidden concessions? Ideas for improvement?

B. Set rental rates w/market savvy**:** Most owners devote far too little time to this. Their rents reflect personal whim, not market realities.
  (1) Consider a rent-range é units differ (size, view, landscaping, condition, storage, colors, etc) and so should their rental rates.
  (2) The higher the rent é the higher the vacancies and turnover.

C. Raising rents: Immediately boost NOI, which increases building value.
  Indications that rents can be raised:
  - ĭ Waiting lists
  - ĭ Low turnover rate
  - ĭ Zero vacancies
  - ĭ Few complaints

  Why owners under-price their units:
  - ĭ No mortgage expenses
  - ĭ Low hassle (complacent tenants)
  - ĭ Market ignorance
  - ĭ Charity

Find buildings owned by older persons suffering burnout. They purposely charge low rents in exchange for low hassle, low turnover, and low vacancy. Offer to buy their properties "as is" with seller financing. Often the payments you make are higher than the rents they have been receiving.

How high can you raise rents? Test high, then back-down if necessary
- ĭ Test advertise é if you get 6 calls in a day, you can go higher. If you have a unit vacant for 2-3 weeks, you are probably too high.
- ĭ Ask for bids é ask them how much they are willing to pay.
- ĭ Call-backs é follow-up with competitors to see what they are getting.
- ĭ Selective increases é end units, upstairs unit, better view, less noise

Talk with current tenants personally. Provide them with their best deal, not the cheapest deal. Do not arbitrarily raise rents … at the end of the day, you want them in your property because *there is nothing they like better for the same price.*

To accelerate your wealth-building, create value through improvements and changes.

<u>CHAPTER #8</u>: Build Equity Fast with Interiors

<u>Entrepreneurial Imperative</u>:
Many people were burned in the last stock market dive, and they have shifted their assets to real estate. I believe the rush will continue because too many investors are chasing too few good properties.

Low-to-moderate income properties are the only "instant" equity deals I am finding (value creation by quick rent increases). These properties make a great starting point because they yield high cash flows and often sell at affordable prices.

<u>Nuggets</u>:
(1) <u>Selecting tenants</u> é take the *most appreciative* tenant who is qualified, the one who most highly values what you are offering.

(2) <u>Improvements</u> é most entrepreneurs go for the <u>fast</u> buck, not the <u>last</u> buck. Identify those changes that will create the most revenue for the least amount of outlay. Try to create $1 in new value for every $0.50 invested é 2:1 ratio.

(3) <u>Sum effect</u> é imagine the total impact of all your changes on the tenantôs willingness to pay more. A few low-payback items add a ñnice touchò that sweetens the overall pie.

(4) <u>Sharpen the aesthetics</u> é the easiest path to creating value.

- Kitchens and baths é give special attention
- Cleanliness generates profit é pays-back 10-fold, more than any other
- Natural light and views é bright is better than dark
- Special touches é chair railings, track lighting, wallpaper borders, etc
- Functionality é number of electrical outlets, water heater size, a/c capacity
- Safety and security é tenants wonôt rent without it
- Miscellaneous é no loose stair treads, frayed carpets. Put non-skid in tub.

(5) <u>Environmental improvements</u> é seldom payback with higher rents. To deal with environmental issues profitably, secure a large discount at the time of purchase.

(6) <u>Right-sizing</u> é the profit potential tends to favor downsizing rather than upsizing.

- ñOne bedroom + denò sometimes is more attractive than ñ2 bedroomsò.
- Nearly all tenants will pay more for extra storage space é look for dead-spaces that can be brought to life for storage needs (under stairwells, above cabinets).
- Multi-purpose space has added value (Murphy bed, computer desk in closet)

Remember you are not "running a rental property". You are providing people with a home. When you transform rental property into a *home*, you will achieve high rents and low vacancies.

> First, you have to get them inside. Nothing accomplishes this goal better than ñCurb Appealò.

<u>CHAPTER #9</u>: Generate More Income

The BUILDING is your best asset. An attractive, well-kept exterior appeals to a better class of tenants é increasing satisfaction and reducing turnover.

(1) <u>Clean-up the grounds</u>: Remove all trash and eyesores, erect screens to block view of dumpsters or other unattractive areas.

(2) <u>Yardcare and landscaping</u>: Best way to turn an ugly duckling into a showcase property. Create privacy and nice views. Expect to earn a 10:1 payback from your efforts in this area.

(3) <u>Sidewalks, parking areas</u>: Neatness pays, remove oil stains from driveways.

(4) <u>Fences, lampposts, mailboxes</u>: Quality fixtures enhance value, just as rusted, dilapidated fixtures detract from value.

(5) <u>Building exterior</u>:

- ĭ *Appearance* é is there appealing uniqueness, good roof
- ĭ *Exterior condition* é hire a professional inspector
- ĭ *Maintenance requirements* é low-maintenance is best
- ĭ *Signage* é any building with 4 or more units should have a sign

Find good buildings with rundown exteriors, yards, landscaping and fencing. These negatives heavily discount the property's curb appeal and its market value. Improvements to curb appeal will pay-back your investment <u>many</u> times over.

<u>Building names and addresses DO COUNT</u>!

(1) <u>Name it</u>: One of the easiest and best ways to create publicity for your building is to *name* it.

- ĭ If the building you are buying suffers from a bad reputation, <u>change</u> the present name and give it a new one.
- ĭ Link the name with the theme of your marketing, landscaping, design

(2) <u>Change the address</u>: Sometimes the Post Office will assign a new address.

<u>Collect MORE than rent</u>: Look for ways to generate *extra* income.

(1) <u>Laundry</u> é if the units donôt have interior hook-ups, youôll need an on-site facility, or you will be at a serious competitive disadvantage.

(2) <u>Parking</u> é if space is scarce, charge for it (or, charge for a second car). Rent extra spaces to nearby tenants in addition to your own. Charge extra for covered parking.

(3) <u>Storage lockers</u> é pre-fab units might be the answer.

(4) <u>Cable/Satellite</u> é if you can control access, pay wholesale and charge retail, or pass along the savings to your tenants as a ñgood dealò.

(5) <u>Other</u> é think out-of-the-box: commuter van, day care, fitness center, cleaning service, etc.

<u>CHAPTER #10</u>: Creative Ways to Make More Money

Differentiate your property from your competitors AND make more money, too.

<u>Three ideas to maximize profits</u>:

(1) <u>Customize your lease agreements</u>: Most owners focus on iron-clad terms. It is not necessary é use the language of your lease to attract great tenants.

ĭ <u>Explain your advantages</u> é be a good salesman (show-and-tell) about how you offer lower upfront cash requirements, shorter terms, renewals without rent increases, etc.

ĭ <u>Easy to read language</u> é do away w/standard legal forms, work w/attorney to draft a reader-friendly lease. Be a cut-above other owners. Ask for your tenantõs input.

Legalisms bite back. When you take an overly legalistic approach with your tenants, don't be surprised when they respond in kind. Don't believe in the myth of the "air-tight" lease. <u>Bad tenants break strong leases every day</u>.

ĭ <u>What terms are negotiable</u>?

Screening criteria é good people w/bad credit may pay more
Amount of rent é quote a range, ask for a bid
Security deposit é varies based on credit score
Specific improvements é fix the item causing the concern
Pets é problem is not the pets, itõs that they annoy *other* tenants
Wear and tear clause é eliminate for 1-yr leases
Terms of the lease é good tenants may pay more for shorter terms

(2) <u>Furniture</u>: It depends on your target market. The key is to determine how much payback you will get from incrementally adding appliances and furniture.

ĭ Generally, ñfurnishedò implies *low end* é but that is a myth.
ĭ Generally, you can earn high payback by offering some of your units furnished.
ĭ Generally, furnished apartments lease faster, but turnover more quickly.

When you buy a furnished building, value the real estate and the personal property separately. Otherwise, you overpay for the real estate. When you're the seller, try to claim as much extra NOI as possible from renting furnished apartments.

(3) <u>Improve the neighborhood</u>: Higher paybacks than property renovations.

Don't buy in the best neighborhood … buy in the *most profitable* neighborhood. Low-to-moderate income properties yield higher cash-flow. Neighborhoods <u>change</u>. Huge payback occurs when you improve the property <u>and</u> the neighborhood.

<u>Neighborhood revitalization tips</u>:

ĭ Organize a Community Action group
ĭ Find redevelopment money
ĭ Bring in code enforcers
ĭ Lobby government
ĭ Upgrade the schools
ĭ Mutual property improvements