REAL ESTATE RICHES

How to Become Rich Using Your Bankerôs Money
By Dolf De Roos, Ph.D.
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Foreword: Rich Dad ... invest your excess cash and hold your wealth in real estate. It may not be exciting, but if you invest wisely, it will keep you the most happy and secure.

Preface: I took upon myself to make a study of the rich ... they are not uniformly young or old, male or female. I found only two things the rich have in common, almost without exception:

(1) The rich have integrity
(2) The rich either made their wealth or kept their wealth in real estate

CHAPTER 1: Why is Property So Good

Four Magic Questions: Assume you have $100K to invest in securities or property.

> Itôs not just a *little bit* better than other investments, it is *tens and even hundreds of times* better than other investments.

QUESTION #1: With $100K, how may dollars-worth of stock can you buy? Property?

ANS: *$100K* worth of stock, and about *$1 million* worth of property (asset), with rental income. If you bought wisely, rent could cover your expenses.

When you buy securities, you generally have to put up the entire purchase price. When you buy property, lending institutions fall all over themselves to *give* you the money.

The above tells you two things:

(1) Property is considered a safe and secure investment.
(2) Leverage counts ... to buy property, you donôt even need most of the money.

QUESTION #2: The moment you buy your stock for $100K, what is it worth? Property?

ANS: The stock is worth $100K. The property could be worth a lot more! It could have been a *bargain* because of a divorce, ignorance (no appraisal), estate squabbles, foreclosures, etc.

QUESTION #3: What can you do to increase the value of your stock? Property?

ANS: Limited options with stocks. With property, the options are unlimited (paint, spruce-up, heating/cooling systems, bathrooms, kitchens, etc). For commercial properties, find a tenant.

QUESTION #4: How can you enjoy the increased value of your stock? Property?

ANS: Sell the stock ... but pay capital gains taxes and reduce the remaining amount that can earn further profits. Refinance the property ... pay no taxes, and you *still* have the full, appreciating investment and growing rental income.

Financial advisors have <u>not</u> yet figured out a way to profit from advising clients to buy real estate.

<u>CHAPTER #2</u>: Conspiracy Theory
The mass media fails to represent real estate investing fairly. They should:

(1) <u>With asset values, compare growth relative to the *capital put in*</u>: Comparing the performance of $100K invested in money markets to $100K invested in real estate is false. A 7% increase in asset value increases your money market investment by $7,000. A 7% increase in your real estate value would be $70,000 on a $1M property purchased with $100K invested.

Leverage works both ways ... the downside is amplified like the upside. But have you ever known real estate value to plummet by 60%, or 90%, or disappear entirely?

(2) <u>With yields, compare income relative to the *capital put in*</u>: The money market account above yields 7%. The $1M property yields rental income (minus mortgage interest and other expenses) plus as much as 4% on depreciation on the structure, as much as 20% on depreciation of the contents, and the value of the property has changed.

Yield calculations on property investments are much more complicated than for bank deposits, and the difference is a real eye-opener.

Real estate is the only investment where the government will <u>give</u> you money when you make a profit ... *not* take it away in taxes.

<u>CHAPTER #3</u>: A Taxing Issue
Many business assets go down in value, or ñwear outò, as time goes by. Businesses are allowed to write-off a portion of the assetôs value every year to help off-set replacement of the asset at the end of its useful life. But, property tends to go <u>up</u> in value. Yet, the government allows you to claim a depreciation allowance. Are they silly? No, the government knows it is <u>not</u> an efficient provider of housing. It actively encourages *private investors* (like you) to provide housing opportunities.

Property is *VERY* tax-friendly. You can claim depreciation on a property year-after-year, even though it may be consistently going <u>up</u> in value!

<u>Example</u>: $200K property (90% loan) $20K in annual rental income with $15K in expenses.
Pre-tax profit = $20K - 15K = $5,000
Depreciation = $9K
Net income = minus $4,000, to be applied against other income
At 40% tax rate, you save $1,600 in tax ... the government has *paid* you!
<u>Yield</u> = ratio of rental income to purchase price = 20K/200K = 10%
<u>Pre-tax return</u> = ratio of income to capital outlay = 5K/20K = 25%
<u>After-tax return</u> = (5K + 1,600)/20K = 33%

Never underestimate the benefits of property depreciation!

<u>CHAPTER #4</u>: Beating Averages Easily

Statistics are numbers looking for an argument.

Stock market growth and real property appreciation may have the same *average*. But stock market growth has a much higher *variation*.

<u>For the investment *sector*</u> ... fluctuation around the average:

(1) If you buy property, it is likely you will realize appreciation similar to long-term national averages ... because the average is consistent, predictable, and even boring.

(2) If you buy stocks, you are taking a bit of a gamble. In any particular year, stocks are less likely to mirror national averages.

<u>For *specific investments* within the sector</u> ... fluctuation around the average:

(1) If there are 100 houses in a development, and 99 have appreciated by 5%, it is almost certain that the 100th has also appreciated by 5%. Properties tend to appreciate in unison because buyers will compare units on the market and forego those out of alignment.

(2) If there are 100 stocks on an exchange, and 99 appreciate by 5%, there is no telling how much the 100th may change in value. Companies come and go (and their stocks), but their buildings and the homes of their employees, tend to stay around for a long time.

Knowing the average increase in stock values does not give us much information about how a particular stock will fare. It's a <u>gamble</u>. Knowing the average increase in property values gives us a *good* idea as to how much a particular property will fare.

Individual stocks vary wildly from national averages because there are so many variables that distinguish one stock from another. Property varies much less ... there is only one variable that distinguishes one home from another. <u>Location</u>.

<u>What if your investment is taken out of circulation</u>?

(1) <u>Property</u> ... it is *rare* (earthquake, fire, redevelopment, etc). But even when it happens, the owner is compensated. Insurance is available and inexpensive.

(2) <u>Stocks</u> ... it is *common* (companies go under all the time). When they do, there is nothing the owners can do about it. There is no insurance.

<u>Beating the averages</u>: I have yet to see a stock market investment strategy that beats the average over the long term. I have a strategy to beat the real estate market:

(1) <u>Invest in *Geography*</u> ... where people go (climate, things to do, desirable places, etc).

(2) <u>Invest in *Demographics*</u> ... Boomers are retiring, and they live anywhere they want.

(3) <u>Invest in the *Seaside*</u> ... the allure is varied and deep-seated. Seaside real estate is going to rise much faster than inland real estate.

Other investments may fluctuate by the minute. Real estate investments are comparatively relaxed ... solid, consistent and sure.

<u>CHAPTER #5</u>: Yes, but ...

<u>Impossible to get 90% mortgages</u>:
Look around, they exist. Check out other banks and institutions. Check out the Internet. Private Mortgage Insurance (PMI) is worthwhile, if it gets you a high percentage mortgage. Borrow as much of the purchase price as possible.

<u>Impossible to ask relatives for financial assistance</u>: Ask the seller. An 80% first mortgage and a 30% second leaves 10% pocketed in cash ... deposit on your *next* investment.

<u>Impossible to survive if I lose my tenant</u>: Get a new tenant. Lower the rent, if necessary.

<u>Impossible to get ahead by depreciating an asset, then paying depreciation-recovery tax</u>: Don't sell the property. If you sell, you've had an interest-free loan of hard (present-day) dollars that you'll repay with soft (future) dollars.

<u>CHAPTER #6</u>: Summary ... Why Invest in Real Estate?

(1) You do not need to *have* much of the purchase price ... borrow as much as possible.
(2) You can buy many dollars-worth *more* than you pay for ... leverage.
(3) You can greatly increase property's value without spending much money ... improvements.
(4) You need not sell to reap the benefits of appreciation.
(5) You need not monitor your properties moment-by-moment.
(6) Property tends to appreciate smoothly and consistently.
(7) Property is very forgiving of mistakes.
(8) Property has exceptional tax advantages.
(9) Property appreciation varies little around the national averages.
(10) It is very easy to do *better* than the national averages.
(11) It is the simplest, most reliable investment vehicle to convert a little financial intelligence into a lot of cold, hard cash.

<u>CHAPTER #7</u>: The 100-10-3-1 Rule

Investing in properties is a numbers game.

Look at 100 properties, make offers on 10, try to arrange financing for 3, *maybe* purchase 1.

**The more properties you look at, the more efficient "shopper" you become.
You need perseverance to make this work.**

<u>CHAPTER 8</u>: Finding Properties

> There is no one magical source for great deals.

<u>Classified advertisements</u>: The small column ad in the local newspaper is the method-of-choice used by owner-sellers who are not using a real estate agent. Whatôs the advantage of not involving a Realtor?

(1) Using their own resources, the private owner-seller may have under-estimated the value of the property.

(2) There will be less competition for the property, compared to MLS, larger ads, websites where *any* agent or buyer can find it.

(3) The owner-seller will not have had as many inquiries as when an agent is involved, and offers may be more welcome.

<u>Real estate magazines</u>: The preferred source of listings, for two reasons:

(1) They usually include a color photo of the property. It will show the property in its best light, but it is hard to be grossly misleading ... as it is with word descriptions.

(2) ñLooking in more detailò normally means simply calling the real estate firm.

<u>Real estate agents</u>: They can offer an ongoing stream of good recommendations that are not always out-in-the-open yet.

(1) Never stick to just one agent.

(2) Work with agents who are investors themselves.

(3) Interview them ... deal with a agent who can speak your investor language.

(4) A good agent will like to deal with an astute investor ... someone who buys *often*.

When agents are fast, knowledgeable and efficient, good investors are grateful for the ease of getting the work done. When agents are lousy, poor investors pack up and go away and the potential competition for properties is lessened.
The good investor wins either way!

<u>Off-market sales</u>: These are properties where the owner does not even *know* they want to sell. The absence of a ñFor Saleò sign does not necessarily mean the owner does not want to sell. Knock on the door ... no law against it. Youôll be rejected more often than not, but an acceptance makes all the rejections worthwhile.

<u>Write your own advertisements</u>: Why wait for someone else to put an ad to *sell* a property in the newspapers ... run your own ads to *buy*. Let the world know you are in the market to buy investment properties.

<u>Other sources of listings</u>: Once people get to know that you are a serious property investor, they will catch some of your fever. People come out-of-the-woodwork to offer you deals, merely because they know you invest in property!

There is often an advantage in being from out-of-town. Locals are affected by perceptions of what is good or bad. You are interested in the *numbers*.

<u>CHAPTER #9</u>: Analyzing Deals

<u>Terminology</u>:

(1) <u>Yield</u> ... A snapshot of the performance of the property. It is:
rental income divided by the purchase price.

(2) <u>Cash-on-Cash Return</u> ... Another snapshot, but better than yield. It is:
rental income (less interest and expenses) divided by capital outlay.

(3) <u>Internal Rate-of-Return</u> ... A far more interesting measure, the <u>motion picture</u> of how cash-flows and property values change.

<u>Example</u>: $100K property with 70% mortgage, after-tax cash-flow $1,000/yr for 5 years. After 5 years, the property will be worth $150K and ownerȇs equity may be $85K.

The cash-flow will be: (a) $ 30,000 <u>in</u> ... downpayment (equity) in the beginning
(b) $ 1,000 <u>out</u> ... received each year for 5 years
(c) $ 85,000 <u>out</u> ... equity at the end of 5 years

Internal Rate-of-Return: Interest rate a bank would have to give you on a $30K deposit to generate $1,000 per year for 5 years and $85,000 at the end.

Software is available to calculate IRR. Once used, it is difficult to evaluate properties without it. See <u>www.dolfderoos.com.</u>

<u>Other factors to consider</u>:

(1) <u>Location</u> ... subjective, but critical. Near good schools and shops (but not *too* near), with good access via freeways and air.

(2) <u>Property with a twist</u> ... something to distinguish it from others.

Let your creativity and imagination run wild.

<u>CHAPTER #10</u>: Negotiations and Submitting Offers

There are very few *rules*! I usually put these four clauses in a contract:

(1) <u>Sign the contract ñAs Nomineeò</u> ... allowing freedom to assign to whatever ownership structure is best later (my own name, company, family trust, etc.)

(2) <u>Make the contract contingent</u> on arranging financing *suitable to purchaser*.

(3) <u>Make the contract contingent</u> on purchaserȇs *attorney's approval* as to title, encumbrances, liens, easements, and other regulatory impositions.

(4) <u>Secrecy clause</u> ... keeps other competitors (buyers, sellers) from knowing your plans.

How to make your offer *seductive* ... staple your earnest money deposit to the contract!

<u>CHAPTER #11</u>: Getting High on OPM

Buying property with <u>O</u>ther <u>P</u>eopleės <u>M</u>oney gears your investment through leverage.

Banks *want* to give you money ... let them!
<u>Sources of financing</u> ... numerous (banks, credit unions, insurance companies, real estate companies, etc). It really doesnėt matter *where* it came from ... all that matters are the terms and conditions of the loan.

<u>Should you pay off the mortgage</u>? No, not on investment properties.

(a) Take the money you *would* have used and purchased another leveraged property.
(b) Paying down principal reduces your interest payments (lessens tax deductions)
(c) Your IRR on the property investment goes down

<u>Closing thoughts on mortgages</u>:

(1) Buy property to acquire debt. The amount of the debt decreases slowly while the asset increases in value. Debt on *appreciating* assets is <u>good</u>. Debt on *depreciating* assets (cars, stereos, boats) is <u>bad</u>.

(2) When you owe the bank $5,000, youėve got a problem. When you owe the bank $5 million, *they* have got a problem. They have a vested interest in looking after you.

(3) Once youėve shown yourself to be a successful property investor, banks will prefer lending you money over anyone else.

<u>CHAPTER #12</u>: Massively Increase the Value of Your Properties (without spending much)

You will either win or learn. And you never learn *less*.

<u>Example</u>: Build a carport for $1,000 and increase rental income by $20/week.

(1) The return on your $1,000 investment is about 100% per annum

But, thereės more ...

(2) Get the property re-appraised. Capitalizing rent at 10%, the value of the property should increase by about $10,000.

(3) Get a new mortgage for the higher value ... 70% loan puts an extra $7,000 in your pocket and you pay $700/yr in extra interest.

(4) When the smoke clears, you have $7,000 tax-free in your pocket and $300 in additional annual income ($1,000 - $700). All for adding a $1,000 carport.

<u>How to increase the value of commercial property</u>:

(1) The biggest way is to acquire it vacant and find new tenants.
(2) Subdivide a large property into smaller ones.

CHAPTER #13: Managing Your Properties

> Managing a property is like owning a pet.
> It is exciting at first. Then reality sets in.

Start by managing your own properties
because it is great training to understand the components of the process. You'll be better prepared to turn the task over to professional property managers.

Tenant selection: This is the *most critical* factor in running your properties smoothly.

(1) Interview candidates ... references are helpful. Good long-term tenants don't mind answering many questions about previous rentals, jobs, locations, etc.

(2) Visit candidates at *their* present home ... if circumstances permit.

Finding tradesmen: No magic formula.

(1) Ask friends and acquaintances.

(2) Join a local property investor's association (if there is one)

(3) How to get a tradesman to do *your* job first, *always* ... pay him the same day you get the statement. Word will soon spread!

Rule enforcement: The biggest mistake is investors trying to be too friendly with their tenants.

(1) Be firm, but fair ... friendly, but not familiar

(2) If tenants know you are fair, but you will take swift action on any breaches, they will respect that ... and seek out a slower-reacting creditor to not pay when money is tight.

Accounting: The financial climate for property investing is so positive, don't even think about any under-the-table transactions. Have a computerized system for accounting, and update it weekly or monthly.

Evictions: One of the toughest things you'll ever have to do

(1) Make sure you abide by all the rules and regulations for evictions.

(2) Word will spread like wildfire that you evict for non-payment.

(3) As soon as rent is overdue, contact them. It is easier for them not to pay someone who never calls.

Professional Property Managers: Every hour spent on managing existing property detracts from your ability to find, analyze, negotiate, finance and own another one.

(1) Not only do they manage the property, they do much of the accounting.

(2) They typically charge 4%-to-15% of the rental income. The bigger your portfolio, the lower commission rate they charge.

(3) Having a property manager enables you to work on your business, not in it.

Develop systems to manage your properties ... and systems to manage your managers. You will benefit not only from Other People's Money, but also Other People's Time.

> When you invest in residential property, you are dealing with *people*.
> When you invest in commercial property, you are dealing with *contracts*.

CHAPTER #14: Residential versus Commercial Property

Residential ... self-explanatory, people live there. I include apartment complexes, but some banks do not.

Commercial ... where any form of commerce is transacted. I include industrial and hospitality properties, too.

Governments have countless rules governing residential property, and they *override* anything you may put into the lease agreement. With commercial property, whatôs in the lease agreement is generally what goes.

Commercial landlords have *far stronger* remedies than residential landlords.

Comparisons:

	Residential	Commercial
Rental quotes:	monthly or weekly	annual
Tenant interest in improving or maintaining property:	no interest	vested interest
Leases:	short (or non-existent)	long
Minor problems:	tenants phone you	tenants fix
Bureaucrats:	protect tenantsô rights	leave you alone
Capital required to buy:	minimal	large
Loans:	90+% of appraisal	50% to 60% of appraisal
Appraised value:	same vacant or occupied	occupied is 2x or 3x higher
Finding new tenant when vacant:	easy (all about same)	difficult (specialized)
Management overhead:	high	low

Of all the extremely high net-worth property investors I know, almost all own predominantly *commercial* properties. I would rather have a large amount of money tied up in *commercial* property rather than residential property.

> More often than not, the effect of government interference is exactly the *opposite* of that intended.

CHAPTER #15: Government Interference

Markets:

(1) The property market is the *largest* industry in almost all Western nations.

(2) Other markets are highly regulated and controlled, but real estate is mostly left to the natural forces of supply and demand.

<u>CHAPTER #16</u>: Eight Golden Rules of Property

> The reasonable person accepts the world. The unreasonable person insists on changing the world. All progress depends on the unreasonable person.

Golden Rules:
(1) <u>Make your money when you *buy*</u>. Most of the profit comes from buying well.

(2) <u>Always buy from a *motivated* seller</u>. Donǥt feel guilty that you are buying at what seems to be a steal. You are still paying him more than his next best offer.

(3) <u>Fall in love with the *deal*, not the property</u>. When it comes to investment property, leave your emotions behind. Do the numbers work? What are the growth prospects?

(4) <u>The first person to name a figure always loses</u>. True in life, not just in property sales.

(5) <u>Be counter-cyclical</u>. Go against the grain. Buy when everyone else is selling, and sell when everyone else is buying.

(6) <u>Always buy with zero or little down</u>. The less money you put in, the higher the returns to you, and the more additional properties you will be able to buy.

(7) <u>Seldom sell</u>: People who sell never do as well as people who keep their properties. However, it is sometimes wise to sell to cut losses or quit a property that is becoming a drain on finances, energy or mental effort.

(8) <u>The Deal-of-the-Decade comes along about once a week</u>. The most important rule.

<u>CHAPTER #17</u>: The World is Your Oyster

> We are going to be dead for a very long time. Make the most of life.

<u>The game of Monopoly versus real life</u>:
(1) You win the game by bankrupting your opponent. In real life you collect rent from willing tenants
(2) In the game, you collect money only when someone unfortunately lands on one of your properties. In real life, I have willing long-term leases.
(3) The game is played on a board. In real life, I own properties all over the world.

You can be a successful real estate investor with no qualifications, and with little money. What it takes is *diligence* and *persistence*.