

Chapter 1

Fundamental Principles of Investing in Real Estate

Buying and selling real estate can be one of the most profitable and lucrative investment activities an individual can participate in. There are many approaches to investing in real estate, most of which are centered around various time horizons. On one end of the investment spectrum is the buy-and-hold strategy where an investor might purchase a property and hold it for many years, and on the other end is the buy-and-sell strategy where an investor might hold the property for only a few months, weeks, or even days. It is the latter of these two strategies that I focus on in this book.

While readers of this book are likely to have broad and diverse backgrounds, you do share one thing in common, that being your interest in real estate and in particular, your interest in flipping properties. I will attempt to be as thorough as possible, since some of you are likely to have little to no experience, while others of you are seasoned professionals searching for that edge. This being the case, those of you who have a great deal of experience may find some of the material to be a bit basic. It is vital, however, that I lay the proper foundation for those who are not as experienced. Many of you have most likely purchased single family houses at one time or another and have at least a minimal degree of rental property experience.

In the next chapter, the concept of flipping properties along with specific types of flipping is more fully discussed. Then in Chapter 3, we examine the notion of a term I coined in a previous book, *The Complete Guide to Buying and Selling Apartment Buildings*, which I refer to as “the value play.” I love using the value play strategy because it is the quickest and surest way to build wealth that I know of when the subject is real estate. In Chapter 4, we explore several methods you can begin using immediately to locate prospective investment properties, and in Chapter 5, we study in depth the most

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common methods of determining value and examine the most appropriate one for use in your analysis. A proper understanding of the valuation process will greatly facilitate the building up of your real estate portfolio. Then in Chapter 6, we examine more fully the practical application of the valuation methods described in Chapter 5 by using various financial analysis models that were created to analyze potential purchase opportunities.

Chapter 7 will help you more fully understand the rules of engagement as they apply to buying and selling properties as we examine the seven steps of successful negotiating. Then in Chapter 8, we study the advantages and disadvantages of many of the methods of financing. We also take a look at the key elements of writing a professional business plan, as well as credit scores, underwriting guidelines, and the closing process. In Chapter 9, we discuss how you can assemble a winning team of professionals to help you maximize your potential. In Chapter 10, we examine the merits of three keys that will better enable you to maximize your potential as a real estate investor.

In Chapters 11 through 14, I have included a section taken from our weekly radio program, “It’s a New Day in Real Estate,” that features a special eight-week investor series. Chapter 15 provides a detailed case study analysis of how to take a house from start to finish through the flipping process. Chapter 16 discusses what I refer to as the three principles of power. These three principles are not just limited to helping you succeed in real estate, but when properly applied, will benefit you in many aspects of your life and will lead to an increase in your level of fulfillment and happiness. Finally, I have included a special bonus chapter titled S.M.A.R.T. Goals. This chapter provides key information that will allow you to accelerate your progress toward achieving financial success by helping you plan and set goals.

BACKGROUND

A convergence of events from my own life experiences over the last 20-plus years has provided me with unique insight into the real estate market. There are three primary components that have contributed to my experience. First and foremost, like many of you, I have bought and sold a number of both single family and multifamily properties over the years, and I am a current and active investor.

Second, my experience as a financial analyst at one of the largest banks in Texas has provided me with a comprehensive understanding of cash flow analysis. Working in the mergers and acquisitions group for the bank, I reviewed virtually every line item of financial statements of related income and expenses for potential acquisition candidates of numerous banks that we may have had an interest in at any given time. I spent several

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hours a day using a fairly complex and sophisticated model to determine the proper value, given a specific set of assumptions, that these banks had. Since leaving the bank some years ago, I have developed my own proprietary model that I now use to facilitate the valuation process for single family, multifamily, and development opportunities. The beauty of understanding cash flow analysis is that once you grasp the concept, it can be applied to anything that generates some type of cash flow, whether it be banks, single family houses, manufacturing businesses, or retail outlets. The type of business is not important, provided you understand the key assumptions that relate to the specific industry you are evaluating. Finally, my experience as a commercial mortgage broker has provided me with an inside look at the lending process, and more specifically, what the lenders' underwriting departments typically require to get a loan approved.

I believe the culmination of my own skill sets and life experiences will be of great advantage to you as you seek to enlarge your personal real estate portfolio. I should mention one additional characteristic of mine, which I attribute more to my personality than to any other factor. It is my inability to be satisfied with any single real estate purchase or acquisition. In other words, the traditional process of buying and holding a property, quite frankly, bores me. Who in his right mind wants to buy a piece of real estate and then just sit on it for 10 or 20 years? I know, I know, a lot of people do, including some of you, I'm sure. For me, however, I can't sit still long enough to hold an investment that long. I am more of a trader of sorts, and as that applies to real estate, a flipper. My personality is much better suited to buying, creating value, selling, and then doing it all over again. It is the thrill of the hunt that I most enjoy. It is finding that next deal, and then exploring every possible way to maximize the value of it. In all honesty, I really don't even care for the work and the repairs that are often required to add value to the property. I prefer to delegate as much of that part of the process as possible to those whose skills are more closely suited to those types of activities.

REAL ESTATE—A SOUND INVESTMENT

The concept of buying and selling real estate properties, or flipping, is indisputably one of the surest means for the accumulation of wealth. Although the strategy involving flipping is itself short-term in nature, let me emphatically state that this book is *not* a get-rich-quick book. I am not aware of any so-called get-rich-quick books that were worth the price paid for them. Garnering a sizable real estate portfolio is a process that can take anywhere from a few years to many years. The patient and diligent investor who applies a well defined and systematic approach over time will enjoy a high probability

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of earning above-average returns for his efforts. As a real estate investor, the fruit you enjoy, however, is directly related to the amount of effort put forth on your part. One is unquestionably a function of the other.

Just as a beautiful and healthy tree requires sunlight, food, and water for proper nourishment, so does the process of building wealth. Leave your fortune to chance, and chances are you will have no fortune to leave. To build wealth, you must plant the proper seeds, and then nourish them with food and water over time. An occasional pruning will also be required. Almost before you realize it, a strong and magnificent tree will begin to take shape right before your very eyes. Although the grand and noble oak tree exhibits towering beauty and strength above the surface of the earth, it is the tree's root system, which extends deep beneath the surface, unseen by human eyes, that gives it force and stability, allowing it to withstand the mighty forces of nature. Like the oak tree, you too, must be well rooted in fundamentally sound principles of real estate before your branches can grow. As you apply the principles you learn from this book, you will eventually be able to enjoy a sweet comfort from the shade that your branches will provide. Although the winds of adversity may descend upon you with great vigor, if you are prepared, they shall not prevail.

To be successful in real estate does not happen by chance. You must have a well-defined plan outlining your specific objectives. Determine exactly what it is you want out of your real estate investment activities and identify your time horizon for accomplishing your goals. Be realistic as well as specific with your objectives. You must begin with the end in mind. In other words, you must know where it is you are going before you can begin the journey to your destination. Otherwise, if you don't know where you are going, how will you know when you get there? I recently traveled to New York City for a business meeting on Wall Street, not far from the New York Stock Exchange. Since I had never been to New York before, the first thing I did was to map out a plan for my trip. I began with the end in mind. The end, the 22nd floor of 67 Wall Street, New York City, New York, was my specific objective. Since I knew that was my destination, it was simple enough to map out a precise plan on how to get there from my point of origin. Inasmuch as I was well prepared when the day for the trip arrived, I was able to travel directly to the city and arrive well ahead of my scheduled time. Only you can determine your destination in life. If you don't have one, then you'll end up exactly where you intended to go, which is nowhere.

You must carefully analyze each property you consider for investment. You cannot afford to shoot from the hip. Proper analysis requires more than a simple review of the property's physical condition and location. To be successful in this business, you must use a comprehensive approach. This book is intended as a guide with which you can develop a format for a complete analysis of each property you consider for flipping. This format,

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when properly applied, will provide you with a significant competitive edge for the simple reason that most investors do not have a system in place. They may have bits and pieces of a system that they use from time to time, but that is usually the extent of it. By following the guidelines in this book, you will no longer arbitrarily buy and hold or buy and sell, but rather, you will truly understand the keys to successful real estate investing. By the time you are finished reading this book, you will know when to pass on a deal and when not to, and even more importantly, you will know *why*. You will have a better understanding of the principles of valuation and how to apply them to your specific market. Proper understanding of this single principle can be the difference between success and failure. Use the tools at your disposal to make prudent business decisions, and real estate will prove to be one of the best and most sound investments you will ever make.

LEVERAGE—THE OPM PRINCIPLE

Most likely you are already familiar with the OPM principle, which stands for “other people’s money.” Your objective is to control as much real estate as possible while using as little of your own capital as possible, and this means that you have to use other people’s money. The name of the game in this business is leverage. The more of it you have, the more property you can control. Borrowed money can come from many sources, including traditional sources such as a bank, a family member, a business partner, or even the seller by carrying back a note in the form of a second mortgage.

Other popular sources of borrowing include a HELOC, more commonly known as a home equity line of credit. Another source of borrowing includes using a line of credit against credit cards. I don’t know about you, but I get several offers a week from various credit card companies, often times offering \$10,000 or more in available credit. In a favorable interest rate environment, there is nothing at all wrong with using these cards as a source of financing for your investments. Be careful, though! Don’t get caught in the credit card trap by maxing out your cards on consumer goods. You also want to be sure that you have structured the purchase of your property in such a manner that will allow you to service the debt on it, whatever the source of that debt is. Debt is a wonderful tool, but like any tool, you must exercise caution and respect when using it. Otherwise you can quickly find yourself in trouble. You must be in control of your debt and must manage it wisely. Do not allow your debt to control you.

Whatever the source of your funding, the idea is to use as little of your own money as possible because that is what your returns are based upon. Your return on investment, or cash on cash return, is derived from the simple ratio of the net cash left over

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after all expenses have been paid over the amount of your original investment plus any out-of-pocket improvements or expenses that require an additional owner's contribution. So in a very simple example, if you paid all cash for a \$100,000 house that generated \$6,000 of income, your return on investment is 6 percent. You may as well leave your money in the bank and save yourself the time and energy that investing in real estate will require. On the other hand, if you invested only \$10,000 in the deal and borrowed, or leveraged, the remaining \$90,000, assuming the same \$6,000 of income, your return on investment now jumps to 60 percent. That's how the concept of leverage works. It allows you to take a little bit of your own money and maximize the return on it.

There are a number of popular books about how to apply no-money-down techniques. Many of them are well written and have sound principles. While I am a firm believer in the use of other people's money, in my opinion these methods carry the concept of leverage to an extreme. That's not to say they don't work. I'm sure in many cases they do. By relying solely on these techniques, however, you are restricting yourself to a much more limited pool of available properties to choose from. Let's face it. You are in the real estate business to make money, and time is money. Why spend all of your time trying to find a no-money-down deal when there are far more houses that can easily be purchased with 5 to 10 percent down? I realize that some of you may not have even that to start with and if that is the case, then you may have to search for that nothing-down deal. I would encourage you to build as large a base of capital as possible so that you can quickly and easily purchase some of the more attractive opportunities as they become available. For every one or two nothing-down deals that are available, there are at least a hundred deals that can be purchased with 10 percent down. The pool of investment properties available to choose from is much larger at this level. In the end, more choices means greater opportunity, which can potentially mean much more money, and that's what you're in the real estate business for, right?

ECONOMIC HOUSING OUTLOOK FOR THE NEXT DECADE

I recently attended the American Housing Conference in Chicago. Although the theme of the conference was centered around mergers, acquisitions, and valuation methods, Dr. David Berson, Vice President and Chief Economist for Fannie Mae, was there to present the *Long-Term Economic, Housing and Mortgage Outlook to 2010*. In his presentation, Dr. Berson noted several key points with respect to a favorable outlook for the housing industry as a whole over the next decade.

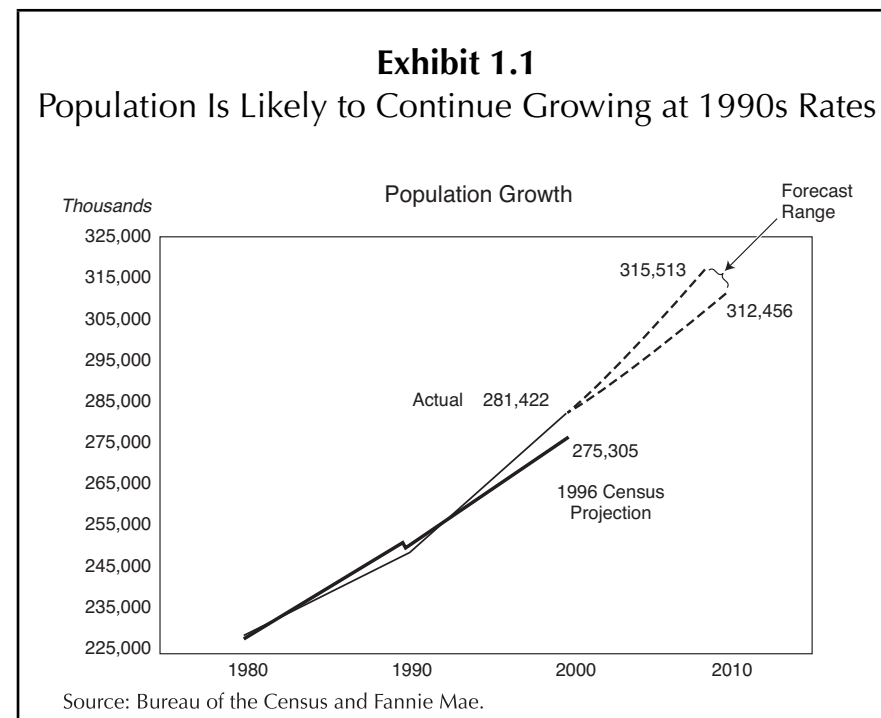
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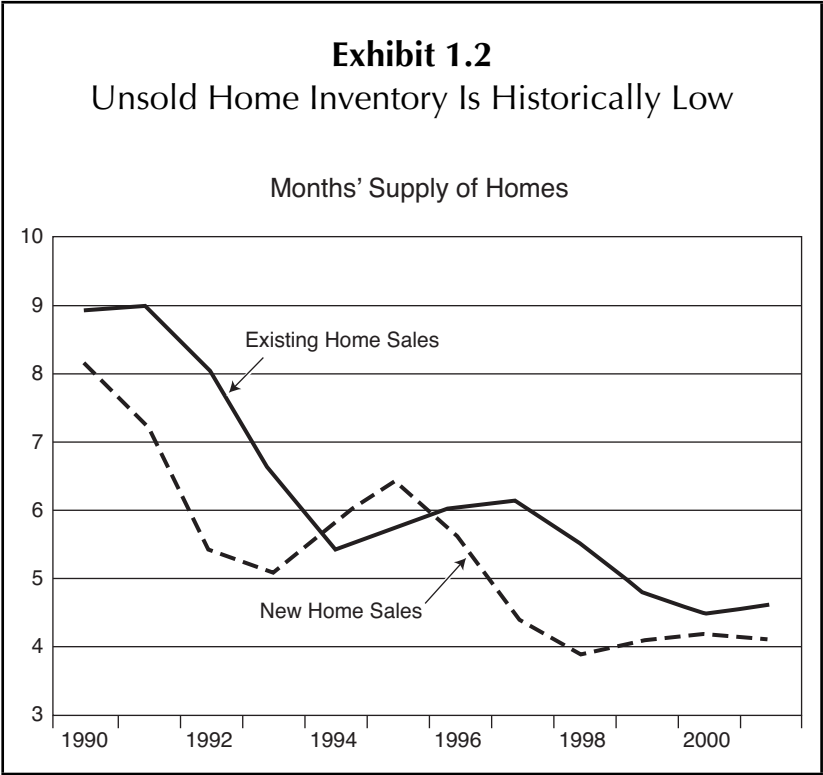
Table 1.1 Historical and Projected Economic and Housing Activity

	1980s	1990s	2000s
Real GDP growth	3.2%	3.2%	3.4–3.5%
30-year FRM rates	12.3%	7.9%	7.2–7.5%
Housing starts	1.48 million	1.41 million	1.64–1.68 million
New home sales	0.61 million	0.73 million	0.91–0.93 million
Existing home sales	2.98 million	4.21 million	5.50–5.64 million
Mortgage originations	\$325.5 billion	\$934.6 billion	\$1,599.4–\$1,808.1 billion

Sources: Commerce Department, Federal Reserve Board, HUD, National Association of Realtors, Fannie Mae Economic Projections.

Dr. Berson's forecast called for average real GDP growth of 3.4 to 3.5 percent, versus 3.2 percent during the 1990s (see Table 1.1). His forecast also expected fixed rate mortgages to be 7.2 to 7.5 percent, versus 7.9 percent during the 1990s. Furthermore, census data for 2010 projected a total population of 315 million, representing an increase of an additional 35 million residents (see Exhibit 1.1). Lastly, the national average of unsold homes is at historically low levels, providing for a tight supply-and-demand relationship





(see Exhibit 1.2). All of these factors combined to present an extremely positive outlook for real estate investors.

There you have it. The stage has been set. According to Dr. Berson, you should be able to enjoy many opportunities over the next decade to successfully participate in one of the most exciting industries of all, the real estate industry. The methods outlined in this book will enable you to effectively and profitably capture a portion of the many profits that will be generated over the coming years. It will be up to you to use the tools provided herein to achieve the level of success you desire.

What lies behind us, and what lies before us, are tiny matters compared to what lies within us.
—Ralph Waldo Emerson