CHAPTER 1

Flip, Fix, Renovate, Convert: Quick Paths to Profits

Would you like to double or triple your money in 12 months or less? Would you like to build quick profits of $10,000, $20,000, $100,000, or more—even though you lack cash or strong credit? Do you want to learn a moneymaking skill that you can put to work anywhere in North America (or, for that matter, almost anywhere in the world)? Would you prefer to work (full- or part-time) without set hours and without a boss looking over your shoulder? Would you like to achieve mid- to long-term financial freedom and personal independence?

If you answer "yes" to any of these questions, I've written this book for you.

In this book, you will learn how to earn big profits as you *entrepreneurially* create value for the buyers and tenants of your properties.

To maximize profits, entrepreneurs strategically improve their fixers.

As a real estate entrepreneur, you will easily discover properties that you can buy for less than the profit potential they offer. But you won't just slap on a fresh coat of paint, lay down new carpet, and wash the windows. You will *strategically* improve the property to favorably distinguish it from competing properties. You will shape its features toward a select and profitable target of buyers, tenants, or investors. You work with your mind, not necessarily your hands.

Buying Right, Fixing, and Flipping Yield Great Profits in Any Market

In many cities today, high prices, low cash flows, and sluggish sales *seem to* signal the end of real estate opportunity. The media certainly promotes this dismal view. But, in fact, real estate pros laugh about the biased, no-nothing reporting of most journalists who write and broadcast articles on real estate—especially those silly scribes who write for the national personal finance magazines.[1]

And we pay no attention to media pundits (economists, financial planners, and others erroneously referred to as experts) who eagerly voice opinions just to get themselves in the news.

In periods of growth, we love our rapid buildup of equity (but strong buyer competition for properties—especially from amateurs who overpay—make good deals tougher to find). In cooler times, good deals multiply. As rapid market appreciation recedes until another day, as the greater fool momentum takes a vacation, we pros love the now open playing field where we can execute our entrepreneurial skills to create value.

In all times, properties offer promise for profitable improvement. But the most frequently recommended fix-up approach fails to adequately tap your imagination, intellect, and creativity. Indeed, the traditional fix-up approach almost encourages you to stifle yourself. "Appeal to the largest possible audience," authors advise. "Keep everything neutral. Don't offend anyone. Don't venture into the unknown. Sure, you might throw in a few *gee-whiz* features like a skylight or hot tub, but for the most part, just focus on clean and fresh."

Although such an approach can earn profits, it tosses out an entrepreneurial vision. It doesn't maximize profits. This common approach only steers you to rundown houses that you can buy at a steep discount. If no repairs are necessary, no deal. No bargain price, no deal. Consequently, when you adopt this bland, routine approach, you pass by many properties that could yield great returns.

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[1] See, for example, one of the most foolish articles of this breed, "Stocks vs. Real Estate," *Money*, April 2007.

The Entrepreneurial Approach

Most beginning investors who fix and flip follow the traditional approach: Find a motivated seller who owns a property that looks bad and smells bad. Negotiate a bargain (below-market) price. Make cosmetic improvements. Resell at a profit.

If you follow this traditional approach to flipping, you will make money. But you won't make as much as you could. The deals you do will leave money on the table. Many deals you pass up—often because negotiations fail to give you a below-market price—sometimes overflow with possibilities that you have not learned to envision.

In contrast, adopt the entrepreneurial approach and you will capture profits the "look bad, smell bad, below-market price" approach misses. What is the entrepreneurial approach? Here's a description from Suzanne Brangham, author of *Housewise* (HarperCollins, 1987):

> As you compare neighborhoods and properties, keep your eye out for ideas you can use to improve the houses and apartment buildings you evaluate. Although most books and articles on real estate investing tell you to buy fixer-uppers, keep in mind that a fixer-upper is *any* property that you can redecorate, redesign, remodel, rezone, expand, improve, or romance. The name of the game is profitable creativity. You can make nearly any home or apartment [or neighborhood] live better, look better, and feel better. To profit from renovation, the properties you buy need not look like they've been mistreated and neglected for the past 20 years.

Entrepreneurs can create value with "perfect" properties.

Throw out the idea that only rundown properties define a "fixer-upper." Sure, poorly maintained properties offer good potential for value-enhancing improvements. But to keen observers, even meticulously kept properties aren't immune to profitable change. When you stay alert to opportunity, you can make any property more desirable to potential buyers or tenants. Consider the experience of Raymond and Annie Brown.

The Browns Create Value in a Down Market

When Raymond Brown and his wife, Annie, bought a vacation retreat home they call Woodpecker Haven, Raymond says, "I thought it was a done property. It was only five years old."

Annie, though, thought about property from a value-creating perspective. As an interior designer with a forward-looking imagination, Annie simply remarked that the house "had great potential." As Raymond tells the story, "Here are some of the improvements my enterprising wife accomplished to transform a livable property into an exquisite home:

- Landscaped the front and rear yards
- Installed a drip irrigation system
- Built a stone fence around the pool
- Added decks around the rear of the house
- Installed in both bedrooms French doors that led out to the decks
- Remodeled the guest bedroom and bath to create a master bedroom for visitors
- Built in a fireplace, bookshelves, cabinets, and track lighting in the living room
- Trimmed trees and shrubs to enhance a picture-perfect view from the front porch"

Although Raymond and Annie invested $75,000 in these and other improvements, they added $175,000 in value—throughout a falling market. "We bought our Sonoma retreat," says Raymond, "just as property prices were peaking, and sold several years later, two months before prices bottomed out. . . . Yet we made a $100,000 profit. Our secret? Woodpecker Haven was a fixer-upper we renovated inside and out."

Build wealth in a falling market.

If it can look better, live better, or generate more pizzazz, it's a "fixer."

The Browns prove that a fixer is any property that could look better, live better, and feel better than it does. (Remember, at the time they bought the property, Woodpecker Haven was only five years old. Recall, too, the Browns made their big gains in a *falling* market.) To fix up a property (or neighborhood) may require you to scrape encrusted bubble gum off floors and counters, patch holes in the roof, fight a gnarled mass of weeds and debris in the backyard, pull out and replace rusted and obsolete kitchen and bathroom plumbing fixtures, or lobby city hall for cleaner streets, more services, and improved schools. But fixing up a property also can mean visualizing ways to redecorate, redesign, remodel, expand, or bring romance to the property.

My Awakening

Like most property owners and renovators, I originally adopted the boring fix-it approach to buying and improving my rental properties. Then, when I was enrolled in my doctoral program at the University of Illinois, I chanced upon a talk about real estate with one of my professors. He told me that after building a new house he (unsuccessfully) tried to sell his previous home. A year on the market, the house remained unsold, so the professor placed a tenant in the property. He asked if I would be interested in buying the house. I agreed to take a look.

Great House, No Appeal The house was located in a desirable neighborhood only a short bike ride from campus. As to physical condition, the house showed no disrepair. No buyer would have called this house a fixer. Yet, when I thought about making the house my home, I backed away. The house lacked warmth and cheer. It was dark inside. The color schemes made army olive look bright. Heavy custom-made drapes in the living room and bedrooms (of which my professor was especially proud) also added to the home's dreary feel.

Earn a 5:1 payback for imaginative improvements.

"Thanks, but no thanks," I told my prof. Then, fortunately, a more creative friend visited the house with me and immediately began to visualize the changes that she would make to the house if she were to live there. With relatively minor changes, she could transform the property's look, feel, and livability. She proved to be right.

I did buy the property, made the suggested changes, and quickly resold the house at a price higher than my professor had been asking. My payback on out-of-pocket expenses was about five to one.

Create a *My Fair Lady* makeover.

A Home, Not a House From that moment, I changed my perspective on fixers. I realized that to most profitably improve a house (or apartment unit) you must first think of it as a *home*. Then, abandon the mere fix-up mentality in favor of transformation. Don't merely dress up the property in a new outfit. Think of your work as Henry Higgins thought of his Cockney drudge in the movie *My Fair Lady.* Indeed, the profitable technique of "home staging" puts this principle into practice. Home stagers transform utilitarian houses into "fair ladies."

Unlimited Potential

To envision improvements, recognize that profitable properties come in all sizes, shapes, and types. Yes, judge a property for its fix-up potential but also envision more creative improvement. Do likewise for the neighborhood.

You can improve "perfect condition" properties in a dozen or more ways.

Most importantly, evaluate potential improvements through the lens of market strategy. Create that combination of features and amenities for which targeted buyers (or tenants) will gladly pay a premium. Through market study, discover profitable ways to differentiate your properties from those of your competitors (other sellers or owners of for-sale and for-rent properties). Throughout this book you will learn to ask and answer many detailed questions that will help you exploit opportunities that a majority of investors and homebuyers miss. For starters, answer these questions:

1. *Livability.* How can you improve the floor plan, traffic patterns, resident privacy, egress, and ingress?
2. *Living space.* Can you add living space through a room addition or conversion (garage, porch, basement, attic)?
3. *Storage.* Where are the dead spaces that you could enhance for storage? What ideas can you borrow from the California Closet Company to add storage capacity without necessarily adding new storage space?
4. *Income potential.* How might you create independent living space such as an in-law suite or accessory apartment? Can you create private living space for a teenager or live-in help?
5. *Roommate living.* If you plan to hold (or sell) the property as a rental, how might you modify the space or living areas to more pleasantly accommodate roommates or other types of shared living arrangements?
6. *Rightsizing.* Are some rooms or areas too large or too small? Do the room count and functions (bedrooms, bathrooms, great room) best match the needs and wants of your most profitable target market? What changes are possible?
7. *Operating and maintenance costs.* Can you switch from high-maintenance materials to low- or no-maintenance items? What can you do to reduce the utility bills?
8. *Capital costs.* How can you minimize property taxes, property insurance, assessments, or mortgage interest for your buyers (or yourself)?
9. *Aesthetics.* How can you romance the property, add pizzazz, or enhance a bright, cheery, or warm feeling?
10. *Views.* Can you enhance or create a pleasant view? (No, you don't need mountains or lakes. A flower garden or ivy-covered trellis can also provide a pleasing respite.) Can you eliminate any ugly or distasteful view? Can you add or relocate windows?

11. *Landscaping, trees, shrubs.* What can you add? What should you cut? Can you improve the yard's appearance with fertilizer, mulch, walkways, fountains, fish ponds, or fencing? Would a different type of grass grow better or look better?
12. *Security.* In our crime-conscious world, what can you do to diminish the home's susceptibility to break-ins?
13. *Safety.* Can you enhance the safety of the home for children, seniors, or just plain everyday living?
14. *Special-purpose use.* Can the property (or any part thereof) be profitably adapted for use as an office, artist's studio, or rentable storage area? Can you profitably adapt the property to better serve the needs of the disabled?
15. *Site.* Can you rightsize the site by acquiring part or all of a contiguous property or by subdividing or splitting off part of the existing lot? Does the size of the site allow for additional building, storage, or parking?
16. *Neighborhood.* What can you and neighborhood property owners do to upgrade or revitalize the community or neighborhood? Contrary to popular perception, you *can* change the location of a property. You can change the location when you improve the schools, redirect flow-through traffic, beautify properties, or reduce crime.
17. *Neighbors.* Sometimes a thoughtless or hostile neighbor can create value-diminishing problems for nearby property owners. What can you and other property owners do to bring that wayward neighbor into line?
18. *Legal.* What laws and regulations (zoning, building codes, homeowners association rules, easements, deed restrictions, environmental standards, health and safety ordinances) control what you can and cannot do with your property? When you learn the detailed ins and outs of these do's and don'ts, you avoid costly blunders and capitalize on seldom-noticed (or recently emerging) opportunities.

Obtain a change in zoning, a variance, or a special-use exception. You add value to a property. Use zoning codes and ordinances to discipline those scalawag property owners (tenants) whose behavior adversely affects neighborhood property values.

From these 18 possibilities, entrepreneurs create value for their properties. They systematically examine the house, garage, outbuildings, site, neighborhood, neighbors, and all laws, rules, and restrictions that regulate property use and design. Most buyers (and sellers) remain uninformed about many of these potential areas for profitable change. They typically inspect only for needed repairs and cosmetic improvements. They miss some of their best opportunities to enhance their returns.

Profit from the ignorance and oversight of others.

Fortunately, such oversight works to your advantage: First, you face less competition for good properties. Second, due to the fact that sellers often fail to recognize the potential of their properties, you can buy great properties for much less than they are worth. In this sense, I don't necessarily mean far less than a property's current as-is market value, but rather a market value price that still yields a large margin of profit.

Occasionally, you can find steeply discounted prices offered by those motivated sellers that most real estate authors write about. But to succeed as an entrepreneurial fixer, go beyond that limited approach. *Think entrepreneurially*. Multiply your opportunities for profit.

Multiple Ways to Profit

As you master the art of creating value, you can earn your gains and build your wealth in at least five ways.

Fix and Quick Flip

Use the fix-and-flip approach to buy, renovate, and sell a property within a short period. This technique works well to generate fast cash. You can then pyramid these profits to reinvest in larger and higher-profit projects. Suzanne Brangham (the author of *Housewise*) began her

Quickly build up your cash through fix and flip.

fix-and-quick-flip career with an unseemly $40,000 condominium (that she sold six months later for $80,000). Then, over a period of years, Suzanne worked herself through dozens of properties all the way up to multimillion-dollar executive homes.

However, under current tax law, multiple quick flips expose you to income tax liabilities. You need to consult tax counsel to perhaps work these transactions within either a corporate structure, an LLC, or a tax-deferred retirement account such as an IRA or 401(k). Yet, for your first several deals, fix and quick flip can put cash in your bank account faster and more surely than any other legal moneymaking opportunity.

Fix and Flip Slowly (Two Years)

Although current law taxes the fix-and-quick-flip rehabber less than kindly, it treats the two-year owner-occupant far more favorably. If you live in a property for at least two years, your gain of up to $250,000 ($500,000 for a married couple) will land in your bank account tax free! Use this technique five or six times over a period of 10 or 12 years and you could easily build up a nice-sized sum of $500,000 or more.[2]

Fix and flip a personal residence—tax free!

Fix, Hold, Refinance

I generally prefer to fix and hold properties as rentals. This approach helps you pay no taxes on your gain and, after a year or so, you can pull tax-free cash out through a refinance. You can use that tax-free refi money as a down payment to acquire another property.

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[2]For more on this trend, see "Tax Law Is Leading Some to Serial Homebuying," *New York Times*, March 30, 2003, B-8. The *New York Times* archives of past articles are now available online without charge.)

Pull out tax-free cash with a refinance.

For example, in one of my early deals, I paid $106,000 (appraised at $106,500) for a property and put $26,000 down. Then I creatively improved the property for about $15,000 in renovation costs. After these improvements, the property appraised at $150,000. I refinanced and pulled out $40,000 in cash. I placed that $40,000 as down payments on two other properties. Creating value with fixers not only earns short-term profits but accelerates your wealth building with leverage (borrowed money).

(Note that the profits in this example did not occur because I bought at a steeply discounted purchase price. I earned these profits because I knew how to recognize and realize the potential of the property, whereas the sellers did not.)

Fix, Hold, Flip (Trade) Up

Here's another way to pyramid real estate profits and avoid income taxes. Section 1031 of the Internal Revenue Code permits real estate investors to trade up tax free.

Use a Section 1031 exchange to pyramid your wealth and pay no taxes on your gains.

You buy a $100,000 property and through profitable improvement boost its market value to $160,000. You want to invest the equity you've created into a more expensive property. Moreover, assume that a sale would net you a taxable gain of $40,000. Alas, the Internal Revenue Service would claim a chunk of that money. So instead of selling, you find a more expensive property you would like to own. You then execute a Section 1031 exchange. Your full $40,000 of gain (less trading fees) gets counted toward the purchase price of this more expensive acquisition. You pay the IRS nothing.

Repeat the process until you reach your financial goals. You need never pay tax on your equity gains. Your wealth builds tax free. If along the way you need cash, don't sell. Draw tax-free cash against an equity line of credit. (Like all tax laws, various rules apply to this technique.

Consult a tax pro to evaluate the ways you can best execute such a ta-savings strategy.)

The Home (or Neighborhood) You Can't Afford

Although I've aimed this book at investors, homebuyers can put this knowledge to good use. With the run-up in home prices since the late 1990s, some of the most desirable homes and neighborhoods are now priced out of reach for many hopeful homebuyers. If that's a situation you face, apply the creative techniques discussed throughout the following pages. Buy a "fixer" and move into the home or neighborhood that you otherwise could not afford.

Buy a fixer to conquer the problem of affordability.

Vanquish Your Fears: Become an Entrepreneurial Investor

Throughout my career I've talked with hundreds of people who have expressed an interest in buying and improving properties. They know that fixers yield better returns than other investments. Yet, few take the first step. Why? Because they block themselves with a multitude of fears. In reality, *none* of these fears are warranted. I know, because I've been there. Let me recount my own less-than-promising start:

1. *Zero experience.* My entire experience with property improvement had consisted of cutting grass at home to earn my high school allowance.
2. *Lack of cash and credit.* As a 21-year-old college student, I scraped together $1,000 and financed my first purchase with a seller-held land contract.
3. *No technical knowledge.* I did not know anything about electrical systems, carpentry, plumbing, painting, or wallpapering.

I soon found out that I lacked any ability to skillfully pursue these crafts. (Even today, after having profitably bought, managed, improved, and sold several score of properties, I wouldn't try to change a faucet washer or repair a broken window.)

4. *No time.* By age 26, I was carrying a full load of coursework in my doctoral program, teaching at two universities (one full-time, one part-time), and overseeing my portfolio of rental houses and apartments.
5. *Poor economy.* During the early years of my investing, the U.S. economy was in the pits—high unemployment, skyrocketing inflation, a country running out of resources (so we were told), and a supposedly bleak future as the land of the rising sun eclipsed our leadership in manufacturing.

Entrepreneurs build wealth. Most people build a pile of excuses.

Do I tell the facts of my entry into real estate to trumpet accomplishments against tough circumstances? No; nearly every successful investor I know got started under similar conditions—not in the details, but in the sense that they, too, met head-on many constraints of time, money, credit, job, family, knowledge, and experience. Yet, they acted.

They did not build a wall of excuses. They moved forward because they understood that their rewards stood much greater than the potential risks.

Yes, You Need Skills

Investors who succeed vanquish their fears and move forward, but they do not careen recklessly or randomly. They nurture eight skills that distinguish winners from whiners:

1. Search to learn what they really need to know.
2. Delegate tasks and manage others who perform the needed work.
3. Discipline their use of money and time.

4. Open an inquisitive mind that persistently searches for new and better ideas.
5. Accept the challenge of work and productive activity.
6. Accept responsibility and review mistakes.
7. Commit to written personal and financial goals and write a plan for achievement.
8. Love real estate and a sense of accomplishment.

The first seven of these skills lead to success in nearly any field. But for personal and financial success in real estate—and especially in the field of real estate entrepreneurship—enjoy your work.

I love looking at properties, talking about real estate, discovering the latest trends, and all the while trying to figure out how to apply something I've learned to one or more of my properties.

Build wealth without "work."

Each year, I travel the United States to look at properties and explore local markets. On my frequent trips to Europe, Asia, and the Middle East, I do the same. I also read new books that come out in the field and stay abreast of a dozen or more journals, magazines, newspapers, and newsletters.

Yet, none of these activities seem like "work" in the traditional sense of that word. Even though you may not choose such a high level of exploration and discovery, to the degree that you do, you multiply the types of properties where you spot profit potential.

My Promise

Real investors focus on realistic, doable deals.

Unlike many books aimed at beginning investors, this book doesn't feed you pie in the sky. It doesn't send you into the market looking for deals that occur no more than 1 out of every 50 times. It doesn't pretend to give you a canned, step-by-step approach as to exactly what types of properties, price ranges, and neighborhoods provide the most profitable opportunities. Nor does this book provide you phone scripts.

Authors who peddle such nonsense ought to have someone unplug their keyboard.

Why do these step-by-step, everything-you-need-to-know books fail? For at least eight reasons:

1. *Local markets differ.* What worked best in San Diego or Albuquerque last year may next year prove impossible. And it may never have worked in Peoria or Paducah.
2. *Relative prices change.* Like stocks, properties, neighborhoods, and price trends run from hot to lukewarm to cold. To profit most with the least risk, anticipate and monitor cycles.
3. *Target markets differ.* To earn high profits and create value, direct your market strategy toward a well-defined target market. Generic strategies miss the mark.
4. *Competition differs.* Develop your best strategy with full knowledge of competing properties, their features, and their price ranges.
5. *Financing differs.* Great financing can lift a so-so deal into the highly profitable category. Likewise, adverse terms of financing may kill an otherwise good opportunity.
6. *Improvement costs differ.* Costs vary among different locales and among different contractors for the same improvements at the same property.
7. *Originality pays big dividends.* Through vision and market research, discover creative possibilities that give your strategies the difference that sets up the distinguishing difference for your buyers (tenants).
8. *Ideas, not sweat equity.* The largest rewards go to people who think. You can't expect to achieve superior returns if you merely follow someone else's one-size-fits-all do's and don'ts.

The best-seller, *In Search of Excellence* (over five million copies sold), by Tom Peters and Bob Waterman (Harper & Row, 1982), presumed to prescribe the rules of success for corporate America. As evidence, Peters and Waterman showcased 20 (supposed) premier companies. Yet, two years after that book was published, *Business Week* ran a cover story entitled "Oops." It turned out that six of these so-called premier companies had hit the skids. The Peters and Waterman prescription no longer seemed to work.

How does this fact relate to real estate? It illustrates the basic point: To earn quick (or slow) profits in real estate, throw out the simplistic step-by-step instruction manuals. The rules of the game change. You simplistic can't create the future you want by thoughtlessly following the "six easy steps" that might have worked in the past.

Increase your profits. Tailor a strategy to your area.

Instead, stack the odds for success in your favor. Learn to match your strategy to the market conditions that prevail at the time you invest. Craft a business plan to fulfill the most pressing (and profitable) needs of the day.

The foundation principle of marketing, "Find a need (want) and fill it," applies to flip-and-fix entrepreneurs just as it applies to Toyota and Nike. Your properties will generously reward you when you give your customers (buyers, tenants) the best value proposition they can find. That's the principle this book shows you how to put into practice—a principle that sharpens your entrepreneurial vision.