Chapter 1

GET THE SCOOP ON...

To flip or not to flip? ▪ How to determine an investment's profitability ▪ Looking at non-flip real estate investments ▪ How to calculate ROI ▪ Rule number one: Use someone else's money

Establishing Your Goals

As with anything in which you invest your time and money, flipping a property involves a number of basic requirements before you even begin. The most important of these are:

- Determine your goals
- Make sure of your project or investment's profitability
- Compare the desired return on investment (ROI) of your project with that of competing non-real estate investments

There are probably other pre-investment admonitions to consider in any investment, but, when considering a flip, these three are the most important. The reasons for this are simple. Knowing what your goals are will go a long way toward helping you decide whether this is a one-time thing or the start of a fairly regular activity on your part. It will also help you decide how deeply you wish to become involved on a project-by-project basis. Will you stick to cosmetic fixes or get involved in projects that require more time, energy, and money? (I cover these different types of projects in detail in Chapters 3, 10, 11, and 12.)

Should you flip?

If the project doesn't appear likely to yield a profit, there is no sense in even beginning it. After all, why become involved if not for a return on the time and money you'll be investing in the project? Flipping a property without regard to its profitability is *not*, by itself, sufficient reason to do a flip.

Equally important, even if you are certain that your project will return a profit, it still may not be the best use of your funds. Perhaps there is another type of investment in or outside real estate that will result in a better return on your investment than the flip you are considering. It might be some form of real estate investment such as buying foreclosed properties and then immediately selling them at market value, or it could be investing in real estate investment trusts, better known as REITs. It might be stocks and bonds, collectibles, or an assortment of commodities.

Also, the competing real estate or non-real estate investments you might consider may bring you a higher ROI than your proposed flip without entailing the same level of risk. In the alternative, they may bring a slightly lower ROI than your project, but with a great deal less risk, so you may yet decide that there is a better place for your money than in redoing an old house.

It is important to remember that whereas many other types of investments are passive, a real estate flip is anything but. It requires a great deal of time and effort, the value of which, if quantifiable, should also be entered into the ROI equation.

Finally, there is the philosophical question of what we choose to do with our lives. Turning a sow's ear of a property into a silk purse of a house can be very satisfying and that could be worth a few percentage points of profit to some people.

Assessing profitability

"All right," you respond. "So how do I determine whether or not my project is likely to return a profit? And, assuming it appears that it will, how detailed should my comparison be with other investment vehicles?" The answer to these questions is *simple.*

You will be able to determine its likely profitability by *carefully* analyzing the real estate market for such properties, the economy, and costs involved in the process of doing a flip. The cost analysis of the project will include a detailed budget of every single item or expense involved in the project, as well as a few items you might not have thought of if you're relatively new to the game. The following chapters will provide you with a much more detailed guide to doing your profitability investigation.

When comparing your project's ROI to that of other competing investments, in or out of real estate, the depth of investigation you undertake is your own decision. It may be that you've arbitrarily decided on a certain rate of return as satisfactory for your project, regardless of the ROIs of competing places for your money, or you may have decided that if you can yield a certain minimum amount of profit in dollars before tax you'll be satisfied. In that case, your investigation won't likely be as in-depth as it might otherwise be without these predeterminations. Just remember, be as detailed as possible within the scope of your project and your desired ROI. More time spent here can avoid a great deal of worry and unhappiness later in the project.

On the assumption that you haven't made a specific percent or dollar determination as your goal, your comparison will be done by calculating your project's ROI and comparing it against whatever other types of investments have shown in the recent past as their respective ROIs. If, for example, gold has an ROI over a six-month period of 20 percent, and you can stomach its wild fluctuation potential, it may be a better investment than your project if your project will yield only 15 percent ROI.

On the other hand, if you are comparing ROIs with growth stocks and they yield an average of 12 percent, your projected hypothetical 15 percent ROI may indicate that your project is currently the better investment.

You can do a similar comparison with any number of potentially competing investments. But be careful: With the exception of U.S. government debt instruments (Treasury Bills and

> **Watch Out!**
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> So-called growth stocks, although given to fairly high rates of growth, and thus, good ROI, have a tendency to be among the ones most likely to fluctuate wildly in both directions, thus potentially risking a negative or lower ROI if you decide to, or find you must, cash them in at a certain point.

Notes); there is no instrument that I am aware of whose return can be relied upon 100 percent. Whatever the stated interest rate payable on these instruments is, that is the amount you will receive. From there it is very easy to calculate your ROI, and know with certainty that you will receive that specific ROI. All other types of investments can wax and wane as to both value and rate of return on your investment.

Non-flip real estate investments

Another type of competing investment worth considering is a basic non-flip real estate investment. This is the traditional type where the investor buys a property, (residential or commercial—it makes no difference for the purposes of our analysis), rents it out, and, if he or she has planned well, eventually sells it at a profit. The investor's profit at sale will then be used to calculate the ROI of that particular investment. A slight variation on this theme is to purchase foreclosed property, either at auction or from the foreclosing lender, and then either retain it as a rental or immediately turn around and sell it at market value, presumably more than you just paid to acquire it.

Calculating ROI

As simple as it is to calculate ROI, there is often confusion about how to do it. Your ROI is the percentage of your original investment that is returned to you when you sell it. If, for example, you invest $100,000 of your own money into an investment, and you ultimately sell it with a net profit before taxes of $25,000, you have achieved an ROI of 25 percent. That profit you received for your efforts is what's left above and beyond the funds you received that covered your original investment, as well as, in the case of a flip, all of the costs involved in successfully completing the project.

If you invested the same $100,000 as a down payment on the property you intended to flip, along with a loan from the bank of $300,000 that covered not only the balance of the purchase, but also the costs of improving the property before sale, you have still only invested $100,000. The other $300,000 was not your investment. It was money you borrowed to allow you to complete your project. In effect, it was as much a tool as a hammer or table saw. Like these obvious tools, it was a necessary item to complete the project into which you invested your $100,000. Therefore, your ROI is calculated on the investment you made, in this case, $100,000, *not* the total initial cost to you before sale. Therefore, if you were to ultimately sell this property for $500,000, your profit would be $100,000, but your ROI would *not* be 25 percent. It would actually be 100 percent, as it is the percent return on *your* investment, your original seed capital, in this case, of $100,000.

Using someone else's money

Another word of advice is worthwhile at this point: No successful real estate investor, and I mean *no one,* ever got rich by using only his or her own money. The rule, virtually etched in stone, is to use someone else's money to as large a degree as you can, and still have it make sense in your overall budget and plan. If things go south and you lose a large portion of your cost invested, the smaller the portion of the funds expended that is actually your money, the less you actually have to lose.

Watch Out!

The costs of the loan, such as interest, closing costs, and points, must be added to the expense of doing the project when estimating your ROI.

Bright Idea

Use leverage (borrowed funds) to as large a degree as possible, within reason. Borrowing can be from banks or personal acquaintances such as relatives or friends.

There are two exceptions to this general rule. If you are a first-time flipper it may be hard to get someone else's money. Also, if you already have the liability of a mortgage on your own home, then an additional loan for your flip can be difficult to get.

Just the facts

- Once you have done as much comparison and analysis as you feel is necessary, make your decision—flip or don't flip.
- Before you invest any time or money in flipping a property, consider how profitable your investment is likely to be.
- Look at all the potential risks, benefits, and any other factors that could affect that investment's projected ROI, for better or worse.
- Consider a non-flip real estate investment, in which you buy a property, rent it out, and then sell it at a profit.
- As much as is practical, use borrowed funds.