THE REAL ESTATE INVESTOR'S CHECKLIST

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Introduction

Hi, [ProspectFirstName].

Thank you for downloading my book, The Real Estate Investor's Checklist.

Will Rogers famously said, "I had been putting what little money I had in [real estate], [because] there was only so much of it and no more, and that they weren't making any more." Real estate—especially residential real estate—has had a long history of increasing in value, with only a few notable exceptions, like the crisis beginning in late 2007. Although there were sharp declines in prices (a severe and rapid market correction), residential real estate is climbing in value again; many areas of the country have increased by more than 7% from the same time last year. This appreciation, together with the use of leverage ("other people's money") and favorable tax treatment is what makes real estate such an attractive and potentially lucrative investment.

First, let's talk about what real estate is not. Compared to other investments, like stocks, real estate is comparatively illiquid. While you can sell your 200 shares of IBM for today's market price with a simple phone call, selling real estate involves far more effort, time and expense. This means that investing in real estate and enjoying the fruits of that investment requires a certain amount of planning, foresight and time.

Real estate also requires some degree of management. If you own a rental home, for example, there are rents to be collected and maintenance to be kept up. As the owner, you must be aware of the rental market and charge the appropriate rents. If you have any doubts about your abilities as a manager, or if you live any distance away from your investment properties, a competent professional manager can increase your profits and preserve the value of your property. You should give careful thought to whether you can handle the various management tasks, or whether you should engage the services of a property manager. Apart from the day-to-day management of the property, you may find that a property manager can get better prices on repairs and maintenance. You should not be shy about asking what services they can provide, and how they can ultimately increase your profits.

Leverage

Give me a lever long enough and a fulcrum on which to place it, and I shall move the world. Archimedes

We are all familiar with the concept of the simplest of all machines: the lever. Our most distant ancestors found that they could use a stout tree branch and a small log for a fulcrum and move huge boulders with little effort. They were able to multiply their own limited strength by many times. A ten-foot lever with a fulcrum one foot from the end will multiply the user's force nine times.

Financial leverage works the same way. A small investment plus financing controls an appreciating asset. The owner's equity increases at a rate higher than the increase of the whole asset.

Here are some examples:

You have $100,000 cash to invest. You buy a piece of land for $100,000—no mortgage. Over some period, the land appreciates 10%, and it is now worth $110,000. Your equity is now $110,000. 10% appreciation gave you a 10% increase in your equity.

Or you could take the same $100,000 cash and use it to make a 25% down payment on a $400,000 rental property. You take out a mortgage for

$300,000. The property appreciates 10% over the same period the $100,000 land did; it is now worth $440,000. I will disregard the monthly payment and the payment toward principal for this example. Where you started with $100,000 equity ($400,000 minus the $300,000 mortgage), you now have $140,000 equity ($440,000 minus the $300,000 mortgage). Your equity has grown by 40%, even though the property itself has only increased in value by 10%. This is the value of leverage. As our buddy Archimedes might say, *Eureka!*

These two examples are obviously oversimplifications of what really happens. If you borrow money, you must make monthly payments on the loan, and those payments reduce the money left over from the rent you collect after paying all the expenses of the property. So, let’s look at cash flow, and how it works.

Cash Flow

It's not what you earn; it's what you keep that counts.

Me, and a bunch of other people.

Cash flow from real estate investments is fairly straightforward. We receive income from renters. We pay out expenses (taxes, insurance, maintenance and debt service). Subtracting the expenses from the income gives us cash flow. If the number is negative (total expenses are greater than the income), we have a <u>negative</u> cash flow. We must tap other assets to cover the shortfall and keep the property running. If the number is positive (income greater than expenses), we have that beautiful thing called positive cash flow. We have money left over at the end of each month.

We can use leverage—sometimes referred to as "OPM" for "Other People's Money"—to increase the effect of appreciation in real estate. If our investment goal is more to build net worth than to collect cash flow, we want as much leverage as possible—and that means taking a larger mortgage, but with less cash flow.

You should be aware that leverage, for all its magical ability to multiply the benefits of appreciation, is a two-edged sword. While leveraged equity increases rapidly when value goes up, it deteriorates in a heartbeat when value goes down. Our friends on Wall Street demonstrated this in 2007 and 2008 when the value of their mortgage bonds declined steeply. In some cases, they were leveraged 100 to 1 (each dollar of equity controlled 100 dollars of asset value), so when the crash occurred, they stood to be wiped out.

It is not possible to leverage investment real estate to that extent, but you should still be aware of the risks. Even though we are not likely to see the steep drop in real estate prices anytime soon, there is the risk of vacancy and unplanned repairs. If you have a rental house where you can charge $1,500 a month rent, and your mortgage payment is, say, $1,200 a month, your financial situation could change for the worse if your tenant were to move out. You will have to get the house clean and ready, then find someone else to rent the property. During that time, you still must make the mortgage payment. If this would be a severe hardship, think twice about buying rental property at this point in your life.

Your rental house may look something like this on paper:

Income		
	Rent	2,100
Expenses		
	Mortgage	1,520
	Taxes	417
	Insurance	50
	Maint. & Repairs	58
	Cash Flow	**55**

This rental provides a positive cash flow each month. It's not a huge cash flow, but keep in mind that your monthly mortgage payment ($1,520) includes nearly $400 toward paying off the mortgage; it's a sort of enforced saving plan.

I know what you're thinking. "$55.00 a month isn't a very good return on my $100,000—even with the tax write-offs. I can do better than .66% return." That would be true—if it were the whole story.

Real estate is a long-term investment. The time and expense of selling a property means that you should be prepared to hold it for long enough to offset those costs and let the benefits accrue. Let's see how our rental looks over a five-year period.

As we look at our hypothetical rental house, we should make some assumptions. Let's say that the value of the home increases by 3% each year. Let's also assume that we can increase the rents by 2% each year. When we sell the property, we'll pay a 5% commission.

	Yr 0	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Value	400,000	412,000	424,360	437,091	450,204	463,710
Loan	300,000	295,161	290,100	284,806	279,269	273,478
Gross Equity	100,000	116,839	134,260	152,285	170,935	190,232
Commission		20,600	21,218	21,855	22,510	23,185
Net Equity		96,239	113,042	130,430	148,424	167,047

Even though the value of the property has increased after just a year, there is no net gain because of the cost of selling. Five years out, however, the gain is substantial—over 67% on our original investment.

What happens to our cash flow as we hold the property?

		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Income		25,200	25,704	26,218	26,742	27,277
Expenses		6,300	6,300	6,300	6,300	6,300
Debt Service		18,240	18,240	18,240	18,240	18,240
Cash Flow (pretax)		660	1,164	1,678	2,202	2,737

We can increase rents slightly each year, but the main expenses for the property—especially the mortgage payment—do not increase. At the end of five years, the cash flow for the property has increased fourfold.

Financing your Empire

If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem.

J. Paul Getty

We have seen how leverage works to increase the rate at which your equity grows. By putting a loan on the property, there is a multiplying effect on appreciation. If you have been paying attention to the media at all, you have been reading how it is nearly impossible to get a mortgage these days—especially one for an investment property.

Newspaper editors sometimes say, “If it bleeds, it leads.” Bad news seems to sell better than good, so stories about the difficulties of getting a mortgage abound. The truth is that, while the mortgage application process is far more rigorous than it was, money for real estate is plentiful.

The biggest change in the mortgage process is that the requirements for documentation have increased dramatically. There are no more “stated income” loans where the lender takes your word for what you say you earn, with no income documentation required. You will have to provide tax returns for at least two years, along with current pay stubs and bank statements. If you presently own rental property, you will have to provide leases for your tenants, as well as documentation confirming what your hazard insurance premiums and property taxes are. If there are unidentified deposits on your bank statements, you will have to provide a “paper trail” showing where the money came from.

When a lender looks at the loan application, it is making some critical calculations. The first is the Loan To Value ratio (LTV). This is the loan amount expressed as a percentage of the purchase price. In our $400,000 example earlier, we had a $300,000 loan, so the LTV was 75%.

It is possible to get a loan for investment real estate for a higher LTV, but the cost goes up dramatically. If you wanted to make a down payment of $80,000 rather than $100,000, your cost for that larger loan would be $4,000 higher. Lenders are discouraging investors from buying properties with excessive leverage.

The second calculation the lender makes is Debt To Income ratio (DTI). The lender adds up the buyer’s current house payment, including taxes and insurance. It adds any monthly payments for long-term debt (longer than 10 months). If the buyer owns rental property already, the lender will calculate the positive or negative cash flow from the rental(s). If the calculated number is negative, it will be treated as though it were a debt. If it is positive, in many cases it will be treated as income.

If you are buying a rental property, the lender will take 75% of the projected (market) rent and subtract the mortgage payment, including taxes and insurance. The resulting number will be treated as either a debt or as income, depending on whether it is positive or negative.

The total debt is then expressed as a percentage of the buyer's gross monthly income. If you earn $8,000 per month and your total debt comes to $3,500 per month, your DTI would be 43.75%.

There is another aspect of financing rental properties that you should be aware of. Most loans today are ultimately owned by Fannie Mae or Freddie Mac. Even though you may get your loan from a local mortgage bank, the loan will likely be insured by either of the two agencies. The term, "conforming loan" means that the loan conforms to the requirements of either of the two agencies.

One of those requirements has to do with the number of properties you can own with financing on them. If you own your personal residence, a vacation home and eight rental properties—regardless of the type of financing on them—you will already be at the maximum number of financed properties allowable under Fannie or Freddie. Furthermore, once you own more than four financed properties, the cost of financing others with Fannie Mae or Freddie Mac financing increases. While this is not a show stopper, it is something you should keep in mind when you are building a portfolio of income-producing real estate.

There are some ways around this limitation. One is to consolidate your equities into multi-unit properties, rather than many single-family units. Let's look at how this might work.

You should be aware of some common terms:

- Operating Expenses: This includes all those normal costs of owning the property including (but not limited to) property taxes, insurance, repairs, maintenance, advertising, legal fees, etc. It does NOT include the mortgage payment or depreciation.
- Net Operating Income (NOI): This is the rent collected, less the Operating Expenses
- Capitalization Rate (Cap Rate): This is the NOI expressed as a percentage of the purchase price of the property. A rental property worth $200,000 that generates $12,000/year in NOI would have a Cap Rate of 6.0% (12,000÷200,000). We can use the Cap Rate in another way: if we have decided that we expect a minimum Cap Rate of 7.5% and we know that a building has an NOI of $18,000, the building would be worth $240,000 to us for that Cap Rate (18,000 ÷ .075). The seller may not be willing to part with the building at that price, but at

least knowing the numbers you require as an investor will help you narrow down your criteria.

- Cash-on-Cash Return: This is the amount of cash flow produced by the property before income tax consequences, expressed as a percentage of the cash investment. A property that generates annual pre-tax cash flow of $5,000 will have a Cash-on-Cash return of 5% if the cash investment was $100,000 (5,000÷100,000).
- Mortgage Constant (MC): This is the annual debt service divided by the balance. A 30-year $300,000 mortgage at 4.5% will have a monthly payment of $1,520. The MC is 6.08. MC is useful in evaluating the potential cash flow of an investment.

A property's Cap Rate is a measure of how efficiently it produces income. A $300,000 property with a 5% cap will generate $15,000 per year in NOI. A $300,000 property with an 8% cap generates $24,000. Generally, properties with lower Cap Rates tend to be "nicer" than those with higher rates. Theoretically, a rental home in an upscale neighborhood can attract higher quality tenants, and present fewer management headaches. This theory may or may not prove true in The Real World. As an investor, you may decide that you are willing to sacrifice some rate of return in exchange for owning a "pride of ownership" building.

In general, single-family rentals are less efficient producers of income (lower cap rates) than small multi-unit properties. Let's compare two $400,000 properties: a single-family home in a very nice neighborhood, and a triplex in a working-class area. Both properties are in good condition.

The single-family rental rents for $2,100 per month. The NOI is $18,900, so the cap rate is 4.73% (18,900 ÷ 400,000).

The triplex, also worth $400,000, has three units rented for $1,100 per month. Although the potential rent is $3,300 per month, we should make an allowance for the occasional vacancy (5%). The rent we can expect to collect is $37,620 (1,100 × 3 ×12 – 5%). Our operating expenses will be slightly higher. Let's say we have NOI of $30,470 (Gross Income of $37,620 less Operating Expenses of $7,150). If the price of the building is $400,000, the cap rate will be 7.62% (30,470 ÷ 400,000).

Let's compare cash flow for the two buildings.

	Cash Flow House	
Income		
	Rent	2,100
Expenses		
	Mortgage	1,520
	Taxes	417
	Insurance	50
	Maint. & Repairs	58
	Cash Flow	**55**

	Cash Flow Triplex	
Income		
	Rent	3,135
Expenses		
	Mortgage	1,520
	Taxes	417
	Insurance	100
	Maint. & Repairs	117
	Cash Flow	**982**

The reason for the dramatic difference in cash flow is the cap rate; each dollar paid for the triplex generates more net income than for the single-family house.

There is no free lunch, however. The triplex, with its $1,100 per month rent, will have a different kind of tenant than the $2,100 per month single-family. Along with that lower rent will come higher maintenance demand and a vacancy factor (I have allowed for both here). Only you can decide whether the trade-off is a good one.

For many investors, cash flow is a more important objective than equity appreciation. If you are one of those investors, you might reasonably ask whether making a larger down payment—or even buying with no mortgage at all—might make sense. After all, the mortgage payment is the single largest expense in the examples presented here.

If you were to buy the single-family rental for cash ($400,000), your annual cash flow would be $18,900 because there would be no mortgage. Your Cash-on-Cash return would be 4.73% (18,900÷400,000). This is a far higher return than the .66% Cash-on-Cash return with a $300,000 mortgage on the property. If you are willing to forego the benefits of leveraged appreciation, this could be a good choice for you.

The reason for this large difference in Cash-on-Cash return has to do with the Mortgage Constant. Any time the Mortgage Constant is higher than the Cap Rate, having a mortgage will reduce your Cash-on-Cash return.

But the converse is also true: when the Cap Rate is higher than the Mortgage Constant, the rate of Cash-on-Cash will be higher with a mortgage. We are leveraging cash flow along with growth.

In the triplex example above, with its Cap Rate of 7.66%, we would have a Cash-on-Cash return of 7.66% if we had no loan on the property. Financing the property with a $300,000 mortgage and a monthly payment of $1,520 (6.08 MC), we'll have annual cash flow of $11,780, for a Cash-on-Cash return of 11.78 (11,780÷100,000).

The comparison between these two properties is not entirely fair. Just looking at the difference in rents between the two properties, we can assume that they are located in very different neighborhoods. Multi-unit buildings have certain economies of scale: for one thing, they are likely to have less land for each unit. They will also tend to have a lower cost of construction—there is only one roof and only one set of exterior walls for three units, for example.

Historically, small multi-unit properties (2, 3 or 4 units) have tended to appreciate at roughly the same rate as single-family homes in the same area—so their ability to support more leverage while still generating regular cash flow means that their overall rate of return will be higher.

So what could possibly go wrong?

First, you should keep in mind that investing in rental property is two things: it is an investment, where you put your capital at risk; it is also a business, where you provide a service (housing) to customers (tenants). That business requires a certain amount of skill. As a landlord, you must know how to survey the market rents to charge the right price. You must be a keen judge of character in selecting good tenants. At times you may have to be a proficient handyman. Your ability to do all these things will affect your rate of return.

If you lose a tenant, you will be faced with the task of cleaning the property, making needed repairs and attracting a new tenant. While your property is vacant, you will still be on the hook for the mortgage payment.

If you did not do a good job of selecting a tenant, you could have collection problems. There could be increased wear and tear on the property because of less desirable tenants. That would lead to higher expenses for repairs and maintenance.

One of the benefits of multi-unit properties is that when one unit is vacant, you still have income from the others. This fact would make the inevitable vacancy less traumatic for your checkbook.

Properties made up of four units or fewer are most commonly financed through loans conforming to Fannie Mae and Freddie Mac guidelines. Qualifying for these loans is no different from qualifying for the loan on your own home. The lender looks primarily to you, the borrower, as the determining factor.

What if you have decided to go "all-in" and buy more than four units? You have held your rentals for years now, and have built up a significant amount of equity. What about buying a large apartment building—say, 60 units, for $5 million? How would that work?

Financing large buildings is different from financing single-family homes or triplexes. The banks making these loans typically hold on to them, keeping them in their portfolio, rather than selling the loans to an investor.

Commercial lending looks primarily to the property itself (although the strength of the borrower is important, as well). The underwriter asks, "Does this property with this loan on it make economic sense?" That means, "Will this property provide cash flow after paying all the expenses and paying the mortgage?"

The primary determination of how large a loan the lender will make on an apartment building is “Debt Service Coverage.” This refers to the amount of cash flow that will be available after all the expenses and the mortgage have been paid. Debt Service Coverage (DSC) of 1.25 means that the net operating income of the property will be sufficient to make the mortgage payment with 25% left over. The NOI is 125% of the mortgage payment.

We have an apartment building with an NOI of $160,000. The property is for sale for $2,000,000 (Cap rate = 8.0). We can get a mortgage for 4.25%, amortized over 30 years. The maximum mortgage payment the lender will allow is $10,667 per month (160,000÷12=13,333/mo
13,333÷1.25=10,667).

Working backward with a financial calculator such as the HP-12C, we can solve for the loan amount: $2,168,000.

Wait a minute. Does that mean the lender will pay <u>me</u> to take their money? Nice try. Even though this property will support that larger loan, lenders will limit the loan to value ratio—typically no higher than 75%. In this case, the lender would agree to make a loan of $1,500,000 on this property.

When you evaluate an apartment building for sale, you should not rely too heavily on the statement provided by the listing agent or the seller. The nice four-color brochures they give you may overestimate the rents and understate the expenses. It is very important that you analyze the tax returns for the building and make your own reasonable projections for income and expenses.

Some of the areas where expenses may be understated are property taxes and reserves for replacements and repairs. Property taxes are based on the purchase price of the property, so if you pay $2 million for it, you can expect the annual taxes to be around $25,000. This number is based on a rule-of-thumb figure of 1.25% of the purchase price, but you can get a more accurate figure by looking up the actual tax rate. You can do this by finding the Tax Assessor's website for your county, then looking up the tax bill for the building. The bill will show the tax rate, which you can then apply to the anticipated purchase price.

Another commonly omitted item is reserves for maintenance and replacement. As you reconstruct the operating statement for the apartment building, you should include line items for money set aside to replace carpets, appliances, roof, etc. Even though these are not predictable monthly expenses, they will have to be paid at some point. Once you have reconstructed an operating statement for the property, you will be able to decide whether this property will meet your financial criteria and whether the asking price is even within a negotiating ballpark. Just as with other types of real estate, the real price of the property is what buyer and seller can agree to.

Next Steps

Where to go from here?

If you have decided that investing in real estate should a part of your investment strategy, you should begin mapping out a strategy with your Realtor®, your loan officer, or both. You should evaluate how much cash you have available and define your investment criteria using this as a starting point. The planning phase is critical.

You should also confer with your mortgage consultant to be sure that you will be able to secure the kind of financing you want. Just as anyone planning to buy their residence should be pre-approved before starting the process, you should do the same as an investor. Preapproval is generally a quick process: you will supply tax returns, bank statements and pay stubs at the outset. You may have to produce other documentation as well, depending on the complexity of your own situation. Your mortgage person will be able to explain further.

Compliance

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Dislcosure:

*Consumers wishing to file a complaint against a company or a residential mortgage loan originator should complete and send a complaint form to the Texas Department of Savings and Mortgage Lending, 2601 North Lamar, Suite 201, Austin, Texas 78705. Complaint forms and instructions may be obtained from the department's website atwww.sml.texas.gov. A toll-free consumer hotline is available at 1-877-276-5550.The department maintains a recovery fund to make payments of certain actual out of pocket damages sustained by borrowers caused by acts of licensed mortgage banker residential mortgage loan originators. A written application for reimbursement from the recovery fund must be filed with and investigated by the department prior to the payment of a claim. For more information about the recovery fund, please consult the department's website atwww.sml.texas.gov.**Hawaii Branch | 7 Waterfront Plaza | 500 Ala Moana Blvd., Ste. 402 | Honolulu, HI 96813 | NMLS #365318