MAILBOX MOO-LA.com

How Real Estate Cash Cows Put Money in your Mailbox

BRIAN PATTON, CCIM

After only seven years of real estate investing, Brian Patton was able to support himself and his family solely from the income produced by his rental properties. At the young age of 37, he retired from the day- to-day grind of a 9-5 job. His only job now… to collect the money from his mailbox.

"I handed in my resignation to my boss with such a relief. Mostly a relief that I had finished what I had dreamed of… to use my mind to create freedom for myself and my family."

Take it from a guy who has done it and discover how to:

- Create Consistent Cash Flow
- Cut Your Taxes
- Pick Out the Right Property
- Make Financing Work FOR You
- Leave Your Day Job

Brian Patton, CCIM

P.O. Box 2322

Cumming, GA 30028

www.MailboxMoo-la.com

This publication is designed to provide general information regarding the subject matter covered. However, laws and practices often vary from state to state and are subject to change. Because each factual situation is different, specific advice should be tailored to the particular circumstances. For this reason, the reader is advised to consult with his or her own advisor regarding that individual's specific situation.

The author has taken reasonable precautions in the preparation of this book and believes the facts presented in the book are accurate as of the date it was written. However, neither the author nor the publisher assumes any responsibility for any errors or omissions. The author and publisher specifically disclaim any liability resulting from the use or application of the information contained in this book, and the information is not intended to serve as legal advice related to individual situations.

ABOUT THE AUTHOR

Brian Patton, CCIM, has been educated and trained in many aspects of the real estate industry. Previous experience has included land planning large scale master planned golf communities throughout the United States and foreign countries, land planning mixed use commercial developments in the Atlanta Region, and brokering office, retail, restaurant, and land deals in the state of Georgia.

Included with this experience were several years of developing site plans for commercial, industrial and residential developments. A stint in the public sector, as well as zoning and development consulting work, has afforded Mr. Patton a distinct knowledge of the governmental approval process.

Brian also is an author and publishes a semi-monthly column on real estate issues in seven different newspapers with a weekly copy circulation of 120,000+. He speaks as a lecturer to groups on real estate issues and is a past guest with GA Reia, the largest real estate investors association in the country.

Mr. Patton obtained his Registered Land Planning / Landscape Architecture status in 1993 and his Real Estate licensure in 1993. His designation as a CCIM came in early 2002.

He shares his experiences in investment real estate with readers of this book in hopes that they will someday reach their dreams of mailbox moo-la freedom.

CONTENTS

MAILBOX MOO-LA AND THE CASH COW

Have you ever wondered where the term “cash cow” comes from? Not surprisingly, it ties directly back to a dairy cow.

A dairy farmer takes pride in his best cow, which can produce as many as 7 gallons of milk every day. Milking the cash from his cow requires very little work from the farmer: All he has to provide is some good grass for grazing, a few food supplements and a little TLC, and the cow will give the farmer milk (or cash) day after day, month after month, for years.

While it isn’t practical for most people today to start a dairy farm, there is a way that almost anyone can reap the benefits of their own cash cow. It’s called investment real estate. When done right, investing in real estate can produce cash flow every month — what I call “mailbox moo-lah” — with minimal work and maintenance by the owner. If you buy enough cash cows and take proper care of them, you can generate more money than you ever dreamed possible.

INTRODUCTION

When I was a young man, if you had asked me what it means to be "rich," I would have said having a million dollars in the bank. Without much thought as to what I would do with a million dollars, it seemed like a nice round number and an amount of money that I could only dream about. Growing up in a small town in Mississippi, I thought of one million dollars as an almost unreachable goal — such a lofty goal that should I ever reach it, I would certainly be "rich."

But over time, I began to understand a little more about what it actually means to be rich, at least financially. Most specifically, I came to realize that we all have monthly cash flow needs that make a goal like having a million dollars sort of irrelevant. A mortgage, student loans, car payments, groceries, utilities — these are all everyday living expenses that we all have to pay. So, just having a huge sum of money in the bank doesn't really mean that you're rich, or that you'll be able to pay all your monthly bills.

What's more, if I ever did reach my goal of accumulating one million dollars, what would I actually do with it? Would I invest it, and if so, in what? Stocks, bonds, bank CDs, real estate? What kind of risk would I be willing to take with the money? Who could I trust for advice? What rate of return would I need to meet my monthly expenses?

I did some number crunching. If I put the money in a certificate of deposit, then my million dollars would return maybe $20,000 per year in interest. Would that pay my monthly bills? Most likely not, since that number is below the poverty line for a family of four. That's right: I realized that a million bucks in the bank might not make me rich. Or put another way, it sure wouldn't be enough for me to retire on. Of course, I could tap into the principal, but then the money would eventually run out.

After coming to this realization, I became a little daunted at the task of "becoming rich." But isn't that what we're all supposed to do in America — get rich? I was still determined to make good on my boyhood dream of being rich, but my search for the holy grail took a slight turn: I started looking at the *monthly expense* component of being rich, and at what "rich people" actually do that makes them rich.

WHAT RICH PEOPLE DO

After some soul searching and research, I discovered that rich people do what they *want* to do, *when* they want to do it. They don't have to get up at the crack of dawn, crank up the car on a cold day, drive to the bus line, get on a bus, bounce around to a downtown office building and sit in a cubicle all day, just to repeat it all in reverse at the end of the day. Rinse and repeat for 40 years until retirement.

Rich people live the life they want. They don't answer to a clock. Their schedules are their own, not some arbitrary 9-to-5 dictum. That's what I wanted.

Instead, I was living middle class, paycheck-to-paycheck. Bored to death. Stuck in a cramped dark office. Unable to spend money on anything beyond the essentials. That was my ho-hum middle class life — and it's the life of most people in America.

From the outside looking in, my professional job had lots of prestige. I was the zoning administrator for a local government: a middle-management bureaucrat whom wealthy developers in the community would call to discuss multi-million-dollar real estate development projects in one of the fastest growing and most beautiful cities in the U.S.

But inside I knew I was made for more than this. I knew that a 9-to-5 job wasn't what I wanted to do with my life… having to ask the boss if I could leave 10 minutes early to watch my son's t-ball game, or having to say "pretty please" to have the day off when my parents would visit town.

I knew I was smarter than this and could live off my brain instead of my time. I once heard my pastor say that money is just an exchange for your time. "Time" is your life. After all, time is all we have. So when you trade time for money you are, in essence, trading your life for money. Since we have only 70 or 80 years on this earth, I wanted to make sure I was using my time wisely, not trapped in a job that I didn't like.

Well, that's when I discovered mailbox money. What I really discovered was the art of leveraging other people's "time" to make more "time" for myself. It revolutionized my way of thinking and the use of my time. Now, I am the boss and I don't answer to anyone. I watch every t-ball game I want and I'm there when my older kids get home from school. My income arrives in the mailbox and I don't have to be sitting at my desk to receive it.

THE ROAD TO REAL ESTATE INVESTING

My quest to become rich led me to investment real estate: properties I could buy and rent out to create monthly cash flow. My first purchase of an investment property was pretty easy, because it was the house my family had been living in for about two years. I had changed jobs, and my wife and I decided it was time to move closer to my new job because my commute had become unbearable.

Our first inclination was to sell our old house because, after all, that's what almost everybody does, right? By selling it, we could put the money toward a bigger house in our new location. But the more I thought about it, the more I came to realize that just selling the house so we'd have money to put down on a newer, bigger house might not be the smartest thing to do after all. And it sure didn't seem to fit into my dream of becoming rich.

Now, I'm not a big infomercial fan, but I was watching a late-night infomercial one night when I couldn't sleep. It was talking about buying rental property for no money down. That's when I got to wondering whether it might make more sense to rent our house than sell it. So I crunched some numbers and discovered that we'd only make a $3,000 profit selling the house.

I knew the house would be easy to rent. It was a well-maintained, three-bedroom, two-bath home with a large deck and fenced-in yard on a cul-de-sac, complete with a rocking chair front porch … the picture of Americana. I figured we could rent it for about $1,100 a month and our mortgage was about $800, giving us a positive cash flow of $300 every month. Therefore, we'd make $3,000 in just ten months and everything after that would be gravy.

We ran an ad offering to rent the house in the local newspaper and received a ton of calls. The first couple who showed up had good income and decent credit, and were eager to move from an apartment to a house. So we went ahead and signed a lease with them. I was shocked that it had been so easy. Just as I'd planned, we cleared $300 per month. Not bad for a guy who was making around $2,100 a month after taxes. In fact, it was close to 15 percent of my take home-pay!

We kept the house for many years after that and enjoyed some great cash flow during this time. With this first rental property, I was off and running as a new (and somewhat green) real estate investor. I soon learned that they aren't all this easy, but the key was getting started —taking the initial plunge and at least getting my feet wet. More importantly, I had begun to understand in a very real and tangible way the money-making power of investment real estate — or what I know call "mailbox moo-lah."

This book is the story of what I've learned about making money as a real estate investor. But it's really not about me. What I hope to do is explain as clearly and simply as possible how you can leave your 9-to-5 job and middle-class boredom and enjoy life on your own terms by becoming a real estate investor.

You owe it to yourself to at least give it a try. Our time here on this earth is very short — we should enjoy every moment we can. I hope that I can help you along the way.

CHAPTER ONE – INVESTING

WHAT IS INVESTING?

Let's start with a very simple but important term that's easy to gloss over: investing. What exactly does "investing" mean?

My definition of investing is to give up something today in the hope that you'll receive more at some point in the future. An investor's job is to determine how best to use his or her limited funds to create more funds for the future, while avoiding a myriad of hurdles along the way.

Here are six key investment concepts you need to understand before we can start discussing real estate investing in more detail:

Risk. We face risk every day of our lives. Walking down the street or driving the family car produces some amount of risk, and so does investing. My simple definition of investment risk is "uncertainty of future returns."

How much risk you can stomach and how much risk each type of investment produces is a key question to ask. And I believe that the answer lies in how much you *know* about the

investment. Robert Kiyosaki, author of the *Rich Dad, Poor Dad* series of investing books, says that risk is "not understanding what you're doing."

Traditional belief holds that the higher the risk, the higher the potential rate of return. However, I've discovered that as I gain more confidence in my area of investment expertise, this traditional belief doesn't necessarily apply.

If you ask me to invest in pork barrel futures, it would be very risky for me because I don't know a thing about them. But for someone with years of experience trading and studying pork barrel futures, they're not risky at all. The same holds true for me with real estate. I understand it, so it's not that risky for me.

Not educating yourself about particular kinds of investments is risky, but investing itself doesn't have to be.

Liquidity. In other words, how do you sell your investment? For example, stocks are easily sold: You log into to your online brokerage account and with a few clicks of a mouse you can sell the stock in a few seconds. Or, you call your stock broker and ask him to trade your stock. It can be done in minutes. Therefore, stocks are very liquid.

Real estate, however, isn't so liquid. It takes awhile to sell a piece of property. You have to find a buyer, arrange financing, have an appraisal done, complete title searches, arrange the closing, and finally complete the deal. Real estate is very illiquid because it takes a long time to convert your property into cash.

Management. Do stocks need to be managed? Not really. Maybe you keep an eye on your stock portfolio, but for the most part, you can buy it and forget it. Real estate, on the other hand, is management intensive. Repairs must be done, rents must be collected, taxes and insurance must be paid, etc.

Leverage. This is a key investment concept that many people don't fully understand. Simply put, it is the use of borrowed funds to purchase an investment. Real estate is one

of the few investments in which borrowed funds are routinely used to finance the purchase of property and increase the investor's return. We'll talk about leverage in more detail later in this chapter.

Appreciation. This simply means that an asset increases in value over time. Appreciation is one of the two ways that real estate investors make money. Cash flow is the other way. The differences between the two are discussed in detail in the next chapter.

Taxes. The tax impact of any investment is extremely important. In fact, taxes are one of the biggest expenses involved in most investments. Real estate continues to fodder great favor with U.S. lawmakers, who have made it one of the most tax-advantaged investments available.

CHAPTER TWO - USE OF LEVERAGE

As noted above, leverage is the use of borrowed funds to purchase an asset, such as real estate. If you make money because of this, then it's called positive leverage. Using leverage increases your money-making power by using other people's money, usually a bank's.

One advantage of leverage is that it enables you to purchase more expensive properties. Without financing, most of us wouldn't be real estate investors. Let's face it: Most people can't write a check for $200,000 to buy a rental house, but some of us can find $20,000 for a down payment.

Leverage also allows you to keep more of your own cash to purchase even more properties. This not only enables you to build your income and net worth, but it also helps reduce your risk, since it allows you to diversify your real estate holdings. If you have one or two units in several different suburban locations and subdivisions, your risk is spread out. If a particular location decreases in value because of an unsightly landfill or deterioration of a school district, for example, your other properties may pick up the slack.

But my favorite reason for using leverage is that it increases your overall return on investment. A simple example helps illustrate:

Let's say your long lost uncle passes away and bequeaths you $100,000. What do you do with it? Maybe buy some real estate? Probably a better option than the stock market these days, right?

Let's say that a $100,000 house rents for $1,000 per month. If you pay cash for the house, then your cash flow is roughly $12,000 per year, or a 12% return on investment. Not bad.

But by using leverage, you would put $10,000 down and have a $90,000 mortgage. With a 7% interest rate, your payment would be around $600 per month, resulting in positive cash flow of $400 per month, or $4,800 per year. Admittedly, this is less than you would make if you bought the house in cash. But your initial investment is only $10,000, so you're earning a whopping 48% return on that investment! That's four times the rate of return you'd receive if you paid cash for the house.

This explains why I get excited about investing in real estate and using my bank's money to line my own pockets. Take this example a step further: Let's say you buy 9 more houses with the $90,000 cash you still have. So now you have a total of ten houses, each producing income of $4,800 per year. That's a total of $48,000 per year on a $100,000 investment—still a 48% return and a lot of moo-lah in your pocket. Can you see why I love leverage so much???

Of course, you have to be careful. There are many other things to consider and potential risks with regard to leverage that we'll talk about in later chapters. For now, I'll just share what Warren Buffett, one of the most successful investors of all time, had to say about it: "When you combine ignorance and leverage, you get some pretty interesting results."

CHAPTER THREE - NET WORTH VS. CASH FLOW

There's no question that opportunities abound today for would-be real estate investors. Foreclosures, Real estate owned by Banks, (REO), short sales — in which you negotiate directly with a bank on a property that's in trouble — are also a good opportunity.

But no matter what kind of property you decide to invest in or how you find it, you should first decide what type of investor you are. A lady doesn't buy a dress and then take it home to decide if it fits her style, and a man doesn't buy a sleek sports car if he's a pick-up kind of guy. I believe there are two main styles of real estate investors: net worth investors and cash flow investors.

NET WORTH

A net worth investor makes most of his or her money over a long period of time, but little on a month to month basis, building net worth slowly as the property appreciates in value. Most investors who buy single-family homes are net worth investors: They're counting on the fact that single-family homes have appreciated in value in the past and hope to capitalize on that trend.

The typical single-family home usually doesn't produce a large return in the short run. In my experience, I've found that the average single-family home will produce about .75% of its value per month in rent. This is my personal rule of thumb, and it fluctuates according to market cycles.

Based on this assumption, a home valued at $150,000 will yield a monthly rent around $1,125. Given a down payment of 10%, a 30-year mortgage at 7%, and property taxes and insurance, this home will produce net cash flow of between $6 and $73 per month, not counting repairs and vacancies. That's OK, but it's not going to make anyone rich. The net worth investor is banking on the fact that single-family homes have appreciated in value in the past and hopes to someday capitalize on that trend, when the property is sold.

CASH FLOW

You may have heard the phrase, “Cash is king.” Well, so is cash flow, which is why this is my preferred investing style.

The cash flow investor’s primary goal is to purchase real estate that will produce positive cash flow on a monthly basis. This investor may be willing to give up long-term appreciation in exchange for money in his or her pocket today. Multi-family units, like duplexes, quads and apartments, generally fit this bill. The main reason is that the unit can be bought more cheaply than a single family home due to lower land and development costs per unit, which pushes the lease-rate ratio up to about 1 percent.

So, a multi-family unit that is purchased for $75,000 might produce a rent of $750 per month. Using the same parameters as the single-family home example, this unit will produce cash flow of $170 to $205 per month before repairs and vacancy. As you can see, this small deviation in the lease-rate ratio produces a sizeable difference in monthly cash flow.

CHAPTER FOUR - NEGATIVE CASH FLOW

It amazes me how many people think it's OK to buy investment property that will result in negative monthly cash flow for several years. Why would you buy *any* investment knowing you're going to lose money, even if it's just in the short term (hopefully)?

While this may be advisable in very rare cases, it's usually a bad idea to purchase an income property and lose money from the beginning. If you don't have positive cash flow on day one, you're doing something wrong. I've never purchased property and started out with negative cash flow — it makes no sense to me. If you're in a deal like that, get out or change the terms of the deal.

Can you imagine a conversation like this with my stockbroker: "Hey Brian, I've got this stock I think you should buy. It's going to cost you $10,000 and you're only going to lose about $200 per month." "Wow, what's the upside?" I sarcastically respond. "Well, it might appreciate enough in ten years that you'll make some money. Oh, by the way, in the meantime, you'll have to deal with maintaining your stock, take calls from your stock late at night, and make sure no one destroys your stock until then."

Does this sound like a good investment to you? Doesn't to me, either. Yet, I heard a so-called expert on the radio the other day (I won't mention her name) asserting that having negative cash flow when you first purchase a property is to be expected and is okay.

A friend whom I've tried to counsel on buying rental properties called me the other day. After some small talk, I asked about his new foray into real estate investing. He had purchased a cute little house in a college town. "Hey, John, how's the new rental house?" I asked. "Oh, pretty good. The realtor says we should have some tenants by the time fall classes roll around," he proudly says. "How much will you be getting in rent?" "About $1,100 per month — we'll still be about $200 a month negative." So, he purchased a property that will have *no* tenants the first few months and that will *lose* money on a monthly basis even after he gets tenants who are paying rent. — all because he believes the appreciation will make up for these short-term losses over the long run. Maybe it will, and maybe it won't.

There is only one justification for buying a property that produces negative cash flow: If it is so under-valued, or not being utilized for its highest use, that you *know* you can gain huge appreciation. If you can't change the use of the property to increase its value or be assured of large appreciation, then stay away from it.

Just talk to people who bought beach condos in Florida in 2006 and 2007 in anticipation of appreciation promised to them by optimistic realtors. After all, they argued, the guy before you made 30% in two months, and the guy before him made 30% in a few months flipping it to him. But most of them found out the hard way that there is not always another "sucker" in line behind you. Most of their condos wound up in foreclosure or have hemorrhaged money after the collapse of the Florida beach condo market. These investors listened to the "experts" who said it's OK to buy property with negative cash flow. Many of them even used negative amortization loans, which increased the principal owed every month, thus digging their holes even deeper.

In 2006, a friend of mine approached me with her plan to purchase two beachfront condos and wanted my "approval" of the deal. After looking at the market rents and comparing it to the asking price, I told her I didn't think it made sense. My estimation was that the condos were overpriced by at least 35%. The rents simply did not cover the mortgage, especially after deducting the management fees she'd have to pay because the beach was more than a six- hour drive from where she lived.

Well, I was wrong. The condos weren't overpriced by 35% — but by 50%! Three years later, she was trying to sell them for *half* of what she paid… before the bank took them in foreclosure. Rents dropped and because of the recession, fewer people were vacationing. If she had followed my advice not to buy anything with negative cash flow, she could have waited three years and bought four for the price of the two that she purchased. And they all would have had positive cash flow.

Of course, negative cash flow is also a function of how much money you put down on the purchase. In general, I figure that a property should produce positive cash flow if you put at least 20% down. Obviously, most real estate will produce positive cash flow if you put 50% down, but I rarely recommend such a large down payment for investment property.

As we discussed earlier, the more money you put down, the less leverage helps you and the lower your rate of return. Think of it this way: If you have zero dollars in an investment — for example, if someone gives it to you — then your rate of return is infinite. That's my kind of return, and I try to get as close to that infinite number as possible.

If you ever find yourself in a negative cash flow situation, there are three things you can do to try to solve the problem:

1. **Raise the monthly rent.** Instead of leasing out the entire unit, can you rent out bedrooms with a shared common area? I've done this before to increase monthly cash flow. It's a lot more work and can cause some headaches because it's easy to get embroiled in roommate issues.

2. Don't get into this without your eyes open though. One night at about 10 o'clock (don't ask me why I answered my phone that late), I a got a call from a tenant who had the police on the line. It seems that his roommate had pulled a knife on him. A struggle ensued and someone called the police. And guess who wanted to talk to me on the phone? The deputy tried to scare me by saying he could charge me with "keeping a disorderly house." I don't know if that's a real crime, but I learned my lesson that night. I sat down and wrote a letter to the tenants telling them not to bother me with their problems, but just to pay their rent and leave me alone.

3. **Lower your monthly cost.** I recently renegotiated a loan on a duplex that was owner-financed to me by Mr. Parks. I was having some problems keeping the property rented and was really getting tired of dealing with it, so I called Mr. Parks: "Mr. Parks, Brian Patton here. I just wanted to let you know I'm having some real problems leasing this property." "Oh, that's not good," replied Mr. Parks, a retired landlord who had seen much more of the business than I had and could relate to my emotional energy drain. "Yes, Sir, I'm thinking I'd be glad to give it back to you if you want it," I said. "No, I don't want it back; I'm retired from landlording" he replied. I nervously step into my presentation: "Well, if you'll drop the monthly mortgage payment by 50%, I can keep it working. Of course, you can add it to the end of the note, so you'll get paid back all your money either way." "Let me get back to you in a few days," he said.

   Sure enough, a few days later, I got good news in the mail. He agreed to my request and my negative cash flow problem was solved. I knew that I had bought the property at the right price and had some good equity in it. So, I wasn't worried with the additional debt placed at the end of the loan from the deferred monthly payments.

4. **Sell the property.** If you can't remedy a negative cash flow situation, eventually you need to bite the bullet and sell. Sometimes, it's hard to bail out like this. When you've put so much emotional energy into a property, it's difficult to admit you've made a mistake and realize it's time to dump it. You'll want to try to rationalize that the property will improve, or that you'll find a better tenant who will pay more money. But just think about the energy it pulls from the rest of your life, both business and personal. Sometimes it's better to just dump a dog, take your lumps and move on.

CHAPTER FIVE – VALUE

"How much money is my property worth?" This is the most common real estate question I am asked. It's a question that's loaded with all kinds of other questions.

I consider value to be the amount of money an investor will pay for a piece of property based on his or her objectives. In other words, *the buyer* determines the value ... no one else—not the seller, the realtor or even the appraiser. So, value is an objective factor that reflects the buyer's/investor's own opinions, financial situation, objectives and assumptions about the property and the future economy.

When it comes to real estate, the best thing we can do is take a stab at the value. It is my belief that the value of investment real estate is best determined by the amount of *income* it will produce. Whether it is in the form of cash flow or net worth, income is the most important factor in determining what you should pay for a piece of investment property. You can even determine value for a piece of raw land based on the income it will produce, either as it is (i.e., a piece of agricultural land) or as it could be if developed (with homes or buildings built on it that are generating income from tenants).

Of course, there are other abstract values that can be placed on property, such as sentimental value or a gorgeous mountain view. But even most of these are reflected in the amount a tenant would be willing to pay to rent the property, and hence, affect the value of the property.

I believe that part of the problem with the housing bubble that occurred in years past has been an unrealistic emotional determination of value that has gone on for way too long. If you follow my theory that ALL real estate value is driven by the value of the income it can produce, then you can see how most homes became overpriced. Home values for years have been determined by appraisers who use comparable sales as a guideline. This has always seemed like an overly simple value determinant to me.

Just because your neighbor paid 20% more than his house was really worth because he loved the yard or the granite countertops in the kitchen, shouldn't mean that your house is worth the same 20% premium.

It seems that we may have burst the housing bubble due to a desire to dumb down the valuation of housing. After all, it's pretty easy for appraisers to make comparable sales analyses. And they seem to make sense because the "buyer" determines the value, right? But what if the buyer is "overly exuberant" and overpays for a house? Does that mean that his or her inflated opinion of value is indeed fact?

Over time, most home prices will settle in at a certain level—a level that is pretty close to the value based on the income the home would produce if you rented it out. Housing bubbles burst because eventually, home prices will return to the value based on the income the home would produce. For example, I bought a middle-class house for my family near Atlanta, Georgia and paid $400,000 for it. Good neighborhood, great schools, country club community, etc. It seemed like a good deal at the time based on comparable sales in the neighborhood. But, along came the housing bubble and houses in foreclosure in our neighborhood sold for $225,000. That's almost a 50% drop!

Had I followed my own advice, I would have realized what its' true value was when I first bought the house and that, at some point, it would adjust to that level. My bet is that I could have only rented the house for around $1,800-$2,000 a month, even when I bought it, so it would have produced between $21,600-$24,000 per year in income. Therefore, based on a simple valuation technique using capitalization rates, it would have been worth from $216,000-$240,000—right in line with current foreclosure values.

Interestingly, this helps explain why you seldom see huge market fluctuations in commercial investment property. Most of the time, these fluctuations are the result of over-supply or financing issues. When the supply and demand see-saw gets out of whack, this usually creates downward pressure on commercial properties.

KEY VALUATION CONCEPTS

There are three primary financial concepts that are critical in how the value of real estate is determined. Without a working knowledge of these concepts, investors and Realtors will be at a serious disadvantage in the marketplace. They may sound difficult to grasp at first, but they are integral in understanding how the value of both commercial and residential real estate is determined.

NOI (Net Operating Income)—This refers to the income received from an investment prior to any mortgage debt being deducted from the equation. In general, net operating income is defined as the total possible rents minus a vacancy rate and any operating expenses. Items that are included as operating expenses include:

1. Real estate and personal property taxes
2. Property insurance
3. Management expenses
4. Repairs and maintenance
5. Utilities
6. Accounting, legal, etc.
7. Vacancy

NOI is used to help compare investments without the uncertainty of what mortgage product you'll be using. The vacancy rate is a general rule of thumb depending upon market conditions and the type of investment. It is expressed in a percentage of gross rents. Operating expenses are normally recurring expenses like property taxes, insurance, management fees, repairs, etc.

A simple example helps illustrate: An investment will generate $13,000 in potential rent per year. A 7% vacancy rate would be calculated by multiplying the potential rent by 7%. $13,000 x .07 = $910. If you had an additional $2,000 in operating expenses, you'd have a NOI of roughly $10,000 per year. $13,000 - $910 - $2000 = $9,990

There are two types of NOI: actual and proforma. *Actual NOI*, sometimes called trailing proforma or historical NOI, is the net income produced based on historical calculations. As a buyer, you want to use these numbers for the basis of your offer. Sometimes the seller will refuse to give you these numbers; if so, you should be very cautious. I have run into situations where the numbers were low for a good reason. For instance, maybe the property manager wasn't doing a good job, or there was a large renovation project that affected rents because of vacancy, or the owner had to give concessions to keep the tenants. These are legitimate reasons for low actual NOI, but you still need to insist upon seeing these numbers. I usually like to see at least three years of these numbers.

As an alternative to studying the proforma NOI, you can also ask to see profit and loss statements (or P&Ls). These are the numbers the seller submits to the IRS for tax purposes. They will be the most conservative numbers, since the seller is certainly not going to over-report income or under-report expenses from the property. With these two items in hand, you can get a good feel for the history of the property.

The other type of NOI is *proforma NOI*, sometime called projected proforma or forecasted proforma. These are merely projections of income based on the seller's predictions of rent and expenses. This is most often used by a seller when the actual NOI doesn't look that great. It might be used if, as mentioned before, the property was under renovation and the actual NOI is lower than what the seller predicts in the future. As a buyer, you may want to see this, but don't put too much stock in it. It's merely a guess on someone's part.

Capitalization Rate (or Cap Rate) —This is probably the least understood concept of all. The cap rate is an easy way to compare investments by the amount of net cash flow and their subsequent value. A simplified definition for cap rate is the return on your investment if you paid cash for the property. The formula for the capitalization rate is: Cap rate = NOI / Value.

Let's look at an example. If the NOI from our previous example is $10,000 and you determine that the property is worth $100,000, then your cap rate would be 10 percent. So if you paid $100,000 in cash for the property, you would receive $10,000 in income and, hence, a 10% return. That 10% is also your cap rate. Note that the cap rate has nothing to do with financing of the property (neither does the NOI, for that matter). It is merely a simplified equation to help determine value of a property.

The biggest benefits of using the capitalization rate as a method of valuation are that it is an easy method, it takes into consideration vacancy rates, and it considers operating expenses. Its simplicity, however, limits its reliability, since it doesn't take into consideration financing or the tax impact on the investment.

Internal Rate of Return (IRR)— This method is more encompassing than the previous two concepts. Sometimes referred to as Return On Investment (or ROI), IRR takes the best of the previous two terms and injects the mortgage debt and the amount of your initial investment into the equation.

A quick study of IRR will prove why investors use financing. Let's use our previous example of a property with $10,000 of NOI. With 20% down on this investment and a 30-year mortgage of 7%, the annual income would be reduced from $10,000 to just $3,613 due to the mortgage debt. But the return would *increase* to 18%. (remember our return was 10% without financing) This increase would be achieved even if you held it for five years and then sold it only for what you paid for it. This is a definitive example of how financing greatly enhances your percentage of return.

One common misconception about IRR is that you can determine the percentage of return prior to selling the property. However contrary to this belief, you must receive your initial down payment back and you must be able to calculate a sales price to get an accurate IRR. Of course, we usually project the sales price to determine an IRR when looking to buy property. But, we don't know the true IRR until the property is eventually sold.

While you can invest in real estate and never understand these financial terms, having a working knowledge of them will provide greater clarity in your future real estate decisions.

NET PRESENT VALUE

Another concept that's important to get a grasp of is *net present value*. It's important to understand this concept because most of your income will come in the future.

In my real estate courses, I've taught that a dollar today is worth more than a dollar tomorrow. This is true for two reasons. The first is the effect of inflation on the value of a dollar. Inflation decreases the value of your money every day. If it takes two dollars today to buy a loaf of bread and in five years it costs four dollars, then the value of your dollar has been cut in half. Therefore, your dollar is worth more right now than it will ever be.

The second reason has to do with risk. There is always the risk that you won't get paid in the future, but if you have the dollar in your pocket now, there is no risk. You already have it and don't have to worry about receiving it later.

So, because most of your investment return will happen in the future, it's important to know what that money is worth right now—or its net present value. Using a financial calculator, you can determine the value of future dollars based on what's called a "discount rate" or a "cost of capital rate." This is merely the interest rate that you *think* you would earn on the money in some other investment if you didn't put it in this one. For instance, let's say that to buy a property you have to put $10,000 down. Obviously, you have lost some opportunity with that money.

You could have put it in the bank or bought stock or some other investment. Your opportunity cost, then, must be determined and put into this equation. This rate, which is enumerated as an interest rate, is based upon your individual circumstances. In other words, it's entirely your opinion or your experience that determines what discount rate you will use.

CHAPTER SIX - THE MENTALITY OF A REAL ESTATE INVESTOR

Before deciding to invest in real estate, it's important to understand yourself. Do you have a soft heart? Do you feel for people and their problems? If you're a "softy", it's going to be a tough job for you. I went to collect from a tenant one time who had made a habit of being late with the rent. I knocked on the door and could hear someone stirring in the dimly lit kitchen. The lady comes to the door; obviously drunk or strung out on something. Then the excuses start. "My old man threw me against the wall and knocked a hole in it, and hurt my elbow. So, I had to go to the hospital." "I'm sorry to hear that, where's the rent."

Now, if you think I'm cold blooded and should be ashamed of myself, then maybe being a landlord isn't for you. You'll eventually become immune the excuses people give as I have. Everyone has problems and everyone will give you excuses if you let them. I believe I'm genuinely a good person and I do like to help people. If I sense that someone legitimately needs some help, and is just not making excuses for being a poor money manager, then I will certainly work with them on the rent. There's been many times that I've waived late fees and dispossessory fees (eviction fees) just to keep them in the property as a tenant. But, I am very careful not to let tenants take advantage of me.

If you show weakness, I can GUARANTEE that tenants will take advantage of you. Being merciful is not showing weakness. Firmness and understanding are the keys. Weakness is not knowing when you are being played by a tenant. I once sold two properties to a newbie landlord. I never really had much problem with the units, I just decided it was time to sell them. A few months later, the newbie landlord calls me up crying. "Your tenant cusses me out whenever I ask for rent." This surprised me because I had never had a problem with this tenant. But, after getting to know this landlord a little through the purchase process, I think I had learned her problem.

She was soft and the tenants knew it. Her first problem was “asking for the rent.” As a landlord you “demand the rent” in a friendly manner. There’s a big distinction there. The difference between “asking” or “demanding” is the difference between getting the rent paid or paying the mortgage out of your own pocket.

I would also never allow disrespectful behavior. I treat all my tenants with respect and demand the same from them. If you don’t treat me with respect, then move out. A young couple rented a house from me and there was a problem with a roof leak. Within two days of the call, I had my maintenance guy checking the roof. He did a patch job and thought he had it repaired. A few weeks later a big rain came and there was still a little leak. The wife called to yell and scream about my lack of attention. After several minutes of being berated and disparaged, I finally decided I had taken enough. “If you’re going to talk like this to me, just move out. I don’t need your drama. If you want to be a problem tenant, I can be a problem landlord.” A quick call to the husband explaining the confrontation yielded a more polite conversation. As we finished the conversation, I made it clear that she wasn’t allowed to call ever again. She never did. Problem solved. You must control every conversation and every situation with a strong message, a kind word, and a stern warning if necessary. Failure to do this will yield failure as a landlord.

CHAPTER SEVEN - EVICTIONS

There's nothing like filing an eviction notice that gets a tenant's attention. A nice young lady with two kids kept giving me the run around about her rent in a little ranch duplex she had been living in for about three months. I had been requiring that she pay in money orders, which I always suggest to landlords. She claimed that she had paid the rent, had put the rent in the mail, and that she had receipts to prove it. But, she never would come up with the receipts. I would call her and offer to come by and get them, gave her a fax to send them to, and offered to let her mail them. Funny. I didn't get any cooperation until three weeks into the ordeal when I filed a dispossessory warrant, which is the first step in evictions. Upon receiving the notice from the local sheriff, she actually came up with the rent and I never heard anything else about the disappearing receipts.

Sometimes, you have to let an eviction notice talk for you. That might be the only thing that will get their attention.

In the real estate classes I have taught in the past, I have found the number one problem with new landlords is grasping the day-to-day personality conflicts between the landlord and tenant. After all, this is a people business. Fail to understand people, and you won't understand how to make a profit. If you do your own management, you have to be good with people. You may need to study some psychology books. You must know how to get what you want out of people.

Learn body language. One day, I was having a problem with a Spanish speaking tenant who had a pit bull on the property. This was a violation of his lease and I had concern that it was a dangerous situation for children in the neighborhood. I had warned him verbally and in writing.

One day I finally had enough and gave him one last written notice giving him 24 hours notice to get rid of the dog or face eviction. On the way to file the dispossessory warrant I decided to give diplomacy one more shot. I called my friend Jorge, who was a local translator for the Spanish speaking community. I explained the situation to Jorge and asked him to make sure that the tenant understood the magnitude of the situation. Upon handing the phone to the tenant, I could read in his body language that he was quite upset…his jaw clenched, nostrils flared, head tilted to the side with a look of disgust. However, as the conversation developed (despite the fact that I didn't understand any of the conversation), I could tell he was coming around to my way of thinking. His body language showed he was more open to the idea. After he hung up the phone, it was clear he had conceded the pit bull issue. In his broken English, he assured me the dog would be removed by the end of the day. Jorge was a big help and my ability to read his body language helped in relating the situation to the translator. I was able to keep a good paying tenant and resolve a potentially dangerous situation.

In reality, you almost have to be a politician, counselor, and business partner… all rolled into one. It's one of the hardest parts of owning real estate – managing people. When I worked in the public sector, I used to have a joke around the office: "This job would be great if it weren't for the people." Of course, I was being facetious, because I loved working with the public. But, sometimes you may feel like that about being a landlord. It's important to keep it in perspective. All investments have their problems to deal with. For real estate, there are more people problems. But, where there is more headache, there is more reward. Not only is it more rewarding financially, but it is also rewarding to help people through their problems. To see them through their financial hump and at the same time continue to produce cash flow for your investment is a rewarding experience.

If you need to, take a personality test to discover yourself, and do this before becoming a landlord. If it shows you're too much of a softy, then don't despair; you can still be a landlord. You'll just need to hire a property manager.

One good reason for using a property manager is not having to deal with the real ugly side of being a landlord – eviction. After about three months of dispossessory warrants, pleas for payment of the rent, and court dates, we finally reached the day that the sheriff showed up to kick the tenants out of a three-bedroom, two-bath house with a full basement that we rented in a suburban town outside of Atlanta.

Unfortunately, I showed up, too. The sheriff knocked on the door, and despite the fact we know people are inside, they wouldn't come to the door. So, we commenced drilling the locks open, since the tenant illegally changed the locks and I didn't have a key. The sheriff went upstairs, and without a word the tenants walked out the front door and left. Now came the part of throwing their stuff out on the street, which I admit I did with some glee. After emptying their contents on the road, we started going through them for anything of value. That's when I thought I was going to be shot. They came back with a moving truck. And boy, were they mad. Yelling and screaming. I left that day determined never to be involved in an eviction again. Yes, I would still evict when necessary, but I would never be there when it happened. Although I had a property manager at the time, I thought it would be a good thing to be at the eviction myself. Wrong idea. I'll never do that again. My curiosity and a few extra dollars are not worth getting shot.

Always go after a deadbeat tenant… always. Two years after this family was evicted, the property manager asked me to meet him for lunch. Not being one to pass up a free lunch, I showed up at the local diner, wondering why he wanted to see me. He had a check for almost $2,000. I had hired him to go after the tenant and had pretty much forgotten about it. But, after getting a judgment and doggedly pursuing the tenant, he had the tenant's wages garnished from his job. That was a windfall I had never expected and probably wouldn't have pursued on my own. In this instance, having a property manager really paid off. He saved me the headache and hassle of court and got some of the money that I had lost back for me. In this case, he was worth the money.

A friend of mine, Doug, owns about 30 units of duplexes in a small town outside of Atlanta. He has a special style of eviction. While I don't recommend this method, I have to admit it works for him. It seems a tenant kept refusing to pay the rent. Now, the recommended method is to give the tenant written notice and file a dispossessory warrant at the local court house. However, about 10 minutes before the tenant got home from work, Doug showed up with a 4'x8' piece of plywood and nailed it on the front door. Of course, the tenant got home and called the police. The officer's response was that this was nothing criminal, possibly a civil complaint, and he left the scene.

The tenant went running to the ATM to get the rent. Other tenants in the neighborhood saw this altercation and realized that they would suffer the same fate should they not pay the rent. For Doug, this method worked like a charm. His tenant paid the rent and he gave a clear strong message to the rest of the tenants. Again, while I don't recommend such a method, the principle is clear, be strong with tenant evictions or tenants will take advantage of you.

CHAPTER EIGHT– PROPERTY MANAGEMENT

If you've discovered that you're not the landlord type, then your option is hiring a professional property manager. I've used property managers before and had some mixed success. I once had a house in another city that one of the largest property management firms in the area was handling. The tenant had been paying late, so I wasn't very happy. One day, I received a call from my account rep, at the property manager's office, saying the tenant wanted the screen door replaced. My response was, "The screen door was fine when they moved in. So, if it's broken now, they should repair it… and oh, by the way, have they paid their rent on time this month?" My account reps' response was "Oh, good point, and I'll check on the rent." If you're a property manager, know this stuff before you call your client… I'm paying you to solve the headaches, not make a headache for me. Not long after that I fired my professional property managers.

I learned the hard way some things you need to look out for in a property manager. Of course, you have management fees, but did you know that some will charge an additional administrative fee for repairs? Additionally, some may require "kick-back fees" from whatever contractor they hire to do your work.

That means, if they have a guy put in new carpet for you, that guy may charge an extra dollar per foot to pay this kick back to the manager. I learned this from one of their carpet installers after firing my manager. This is bad business, and probably illegal somewhere.

They'll be mad at me for letting out this little secret, but I think they should be honest and disclose this relationship. You can understand that overseeing the carpet installation does costs some administrative time. And, they should be compensated for it. But, you should know about it from the beginning and it shouldn't be a hidden fee. If it smells fishy, it probably is.

In general, I'm pretty negative on property managers. Their fees tend to be pretty high and your overall costs will go up. The main reason for this is that they have no incentive to save you money. They're like big government. Their only incentive is to save themselves time and trouble. If hiring a certain handyman cost thirty percent more than the going rate, but the guy is less headache for them, then that's who they will hire. Believe me, I experienced it. I can understand their desire to make administration easier, but it doesn't make it more palatable.

If you must use a manager, then my recommendation is to use a small to medium-sized company. Make sure you get in writing all of their fees and that they are clear about whether you are paying any extra for contractor work or cost estimates. Some managers have tried to charge for cost estimates for items such as new roofs, deck repairs, major sheetrock work or other items that are fairly large in scope. I would absolutely not pay for a cost estimate. Run, don't walk, from a property manager that wants to charge these fees. Of course, check their references and keep a close eye on them. No one watches your assets and money like you do. Just be ready for that and you'll be fine with a manager.

One thing you might want to try is to give the manager a maximum cost for repair that can be paid without your approval. I've used a $200 amount before. Basically, anything under $200 can be done without my approval. Anything over $200, I can get my own estimate from my own contractors. This can solve a lot of problems, especially if you like to be a little more hands on.

The manager may not like it too much, but you've got to keep maintenance costs under control. This will be your major source of frustration when using a manager instead of doing it yourself.

On the up side, property managers can usually provide the best leases and forms for the state that you live in. It's important that these be the best, most up-to-date documents possible. A good property manager will have occasional reviews of their forms and leases by a good attorney. You'll want to ask how often this is done. A minimum of once a year is a good idea.

CHAPTER NINE – DEALING WITH TENANT ISSUES

Whether you manage the property yourself or hire a professional property manager, it's smart to know the best ways to find tenants. After all, without tenants you are out of business. I have several ideas that I have used with some degree of success.

1. REFERRALS

It's always good to offer referral fees to your other tenants. I make it a habit to mention to tenants as I see them that we are offering referral fees. I also have put together a small 3 x 5 card that I mail out under postcard rates to remind them of the referral offer. Most people like living around their friends, and this referral will encourage that. It also helps build a long-term sense of community. Having a sense of community will decrease your number of vacancies, as it is very difficult for most people to leave their friends. Encouraging this friendship will help you in the long run. Referral fees normally range between $100 and $250, depending upon the price of the unit. If the referral fee is too high, you will encourage some cheating on the part of existing residents. I've had residents keep an eye out for possible tenants, run to go meet them, and strike up a deal with them to split the referral fee. While it doesn't seem right, I guess if it helps get a tenant, then I wouldn't worry about it too much. It might even help entice a tenant that otherwise wouldn't have shown much interest.

2. ADVERTISING

Obviously, you have to get word out that you have property for rent. In the past, I've tried classifieds in regional newspapers, such as the *Atlanta Journal and Constitution*. I never had much luck at all with that paper, but have had better luck with the smaller community newspapers. If you are looking for higher rent tenants, those that tend to be professionals, you'll want to get a lot of Internet coverage. Most of these tenants will be surfing for a new place to live while sitting at their desks at work. If you can, use both methods. Also, some property managers offer a tenant location program. Instead of the normal full service fees, the property manager will help find a tenant and send you the lead for a smaller fee. These tend to be pretty good services and are generally worth the fee. Whether you do it all yourself or hire a property manager, there are a few key things you will need to do:

a. Always include a picture. If you are using Internet advertising, you have to use a picture. Pictures will capture the attention like nothing else. And, always use a front exterior picture. If you have extra space, include a picture of the kitchen. If you only use an interior shot, then tenants will wonder what you are hiding on the exterior.

b. The best newspaper advertisement I've ever done lists the rent as a per-week amount. Even though I have tenants sign a one year lease, it just seems cheaper if the rent is listed by the week. As a warning, some tenants will think that the place is a transient location when they see this. Just make it clear to them that everyone signs a one year lease and it will calm their fears.

c. Signs - Post a "for rent" sign in the yard. Just a hand written sign is fine. If you have a lot of rentals, you may want to have some signs made by a professional, as I do. The professional sign will make you look like a big company. You're less likely to get trouble tenants, because they expect that a big company will be doing background criminal and credit checks. So, you can head off some problems with this kind of sign.

3. CREDIT AND CRIMINAL CHECKS

You should always complete a criminal and credit background check on all tenants. Most tenants will have some credit problems. It's important to find out what caused these. After you pull the credit, then ask the tenant about it. Make sure you follow all the credit reporting laws, as they can be counter intuitive. In other words, they don't make any common sense. Criminal backgrounds are important. I'm very careful about renting to someone with anything other than misdemeanors. You'll have to make up your mind how important this is to you.

4. ACCEPTING PETS

This can be a tough one. Most pets will cause damage to carpet and padding. No matter how well house broken a pet is, there will be some problems. Sorry, to the cat lovers, but cats are the worst. The spraying and scratched door frames can be expensive to repair. Despite the fact that I would like never to have a pet in a rental unit because of all the problems, sometimes I just have to let them in. So many people have pets now that if you tow a hard line on this one, you will greatly reduce your tenant pool. Just use your best judgment and always charge a non-refundable pet fee. I usually charge $250 per pet. Also, always check with your insurance agent on what types of dogs are allowed. It might surprise you which breeds are considered the most dangerous. Even poodles can be very territorial and can be quick to bite.

5. MANAGER VS. OWNER

Many real estate gurus suggest that you pretend to be only the manager of your units instead of the owner. The reason is that you'll get fewer requests to repair cosmetic issues and hear about their financial problems. The truth is that it actually works. You can put off decisions indefinitely because you have to run it past the owner, who can always be the bad guy. You can get away with being the tenant's advocate to their face, but just delivering the "bad news" from the owner. I've tried that approach and it just feels dishonest, despite the fact that you can hold title in an LLC; and technically, not be the owner. My suggestion is just to be evasive if you don't want the tenant to know you're the owner.

Or, what I generally do is tell them that I'm just one of the owners (my wife is the other one); and I'll have to get back to them after conferring with my partner. I confer with my wife on those big issues and respond back to them with the answer. I want tenants to be honest and open with me; so I think it's best to treat them the same way.

6. BAILING ON THE LEASE

I have found that almost every tenant who is getting ready to bail on the lease will find something that needs to be repaired. I'm sure there's some kind of psychological impulse that makes people do this. Maybe, they are trying to justify to themselves, even if subconsciously, the fact that they are about to break their contract and do something they know is wrong. But whatever the reason, if you get an unusual repair request, or multiple requests, from a tenant whom you haven't heard much from in the past, then beware. You may show up any day to a property to find the tenant has escaped in the middle of the night, owing you rent. This is a people business and your biggest ordeals will be caused by people.

7. SECURITY DEPOSITS

Security deposits are monies you accept upon move-in to cover unpaid late fees, repair costs, and maintenance items that go beyond what is considered normal wear and tear. That is, if the tenant leaves the premises in "ready to rent" condition and there aren't any unpaid fees of any kind, then you will be required to return the security deposit.

Most real estate professionals recommend always requiring a security deposit. However, in tough economic times, sometimes you may have to forego security deposits to find tenants who can afford the rent. Most tenants can have trouble coming up with the equivalent of two months in rent.

I have found over the years that a lot of tenants like to use this security deposit as their last month's rent. Of course, this isn't the purpose of it. But, the tenant may try to ride this out their last month and not pay the last month's rent. This is one reason you should never use the popular term "first and last" in writing or speaking of the security deposit.

I don't know where this saying comes from, but it is confusing to the tenant and implies that the can apply the security deposit as the last month's rent.

I have found that probably 95% of tenants will leave the premises in pretty good shape. The damages of those that don't will probably exceed the security deposit anyway.

Another advantage of not requiring the security deposit is you can normally get more in rent by spreading the security deposit over the first year's monthly rent. Additionally, any escalations in rent in subsequent years are based off of this increased rental amount. This increase in net income increases the value of your property; since as we learned in an earlier chapter, the value is based upon the net operating income. And, when you are selling a property, very little thought is put into the security deposit from the buyer's side. The buyer is just concerned about the net income. So, why not increase your net income and increase the value of the property?

8. PAYMENT OF RENTS

When I first started in the business, I would accept check, cash, or money orders. Over the years, I have grown to detest receiving checks from tenants – obviously, because they are prone to "bouncing." Checks also make it easy to pull a tenant scam called the "ole check switcharoo." A tenant named Deborah introduced me to this little scam the first month of her tenancy. I opened up the envelope, pleased to see that she was on the ball the first month. What I found was a check to the power company for $105. Oops, I thought. She must have switched the checks. Of course, I promptly gave her a call to let her know of the "honest" mistake. She played it up really well and suggested that I come by the office to pick up the right check… but, of course, she had to get it back from the power company. This little ruse took at least three weeks, and I soon learned that she just didn't want to pay the rent. I say "didn't want to" because she made almost as much money as I did in my government job at the time. I eventually had to evict her because it was one little scam after another. Thanks to this experience and others, I now require money orders for two reasons:

1. The funds are secured. Money orders never bounce. They are just like cash.

2. If the money order is lost or stolen, most money order issuers (I haven't found any that don't) have a process to receive a refund. There's usually a small fee of around $15 for the refund, but this is well worth the extra costs to have that capability. In the example above, I would have cancelled payment on the money order sent to the power company, and had them reissue a new one mailed to me.

9. VACANCIES

The bane to any landlord's existence is vacancies. Nothing will cost you more money, more headaches, and more sleepless nights than having vacancies. But, you'd better "cowboy up" as they say out West – because, if you own a rental property, then you will have vacancies. We refer to this inevitable situation as the "vacancy rate." The "vacancy rate" is a percentage of time that you will have vacancies over a year period. It can range anywhere from five percent to twenty percent. Vacancy rate is similar to the unemployment rate… it's the amount of time that your units will be unemployed. Typically, as with the unemployment rate, five percent is about the best you can expect from the vacancy rate. That means that if your gross rents are $10,000 per year, then you should expect to be out of pocket at least $500 in vacancy over the year period.

Now, I used to think when I owned just one unit, that this vacancy rate made little sense. My logic was that either it's vacant or not… so the vacancy was either zero percent or one hundred percent. But, as I began to gain more experience as an investor, I learned that over a lengthy period of time, say five years, the vacancy rate for my units tended to settle right in at five percent per year.

A large part of this is due to turnover rates and how long it takes to get a unit ready to rent again. Even if you had a great tenant who left your unit in perfect shape, there's still a turnaround time. A simple five percent vacancy means that out of the 52 weeks of the year, it would be vacant roughly two and a half weeks out of the year. This doesn't leave a lot of time to clean the unit, advertise, show it to a few people, sign a lease, and work around the tenant's calendar.

When you are calculating cash flow prior to purchase, you should always use this vacancy rate in your calculations. If you're not sure what rate to use, do some Internet research or ask someone else in the business. Just remember that vacancy rates are very geographically dependent. What might be a good number for a nearby metropolitan area may be higher or lower than what you should use for a local suburban property.

Vacancy rates tend to indicate whether the market is in balance. If rates are too high, then that kind of property is over supplied. If rates are low, then there is more demand than there is supply. Of course, different property types will have different vacancy rates. Single family housing will hover around 1 and 2 percent. Multi-family housing should be around 5 and 7 percent. The reason for the difference is that tenants tend to turn over five times as often in multi-family housing than in single family houses. Office buildings and retail tend to be in the 8 to 12 percent ranges.

If your property is within these ranges, then the market is in "equilibrium." It is a market in which rents neither rise nor fall. When the market is in balance, the only construction that is happening is construction to replace old and unusable real estate stock. *The Wall Street Journal* once reported that nearly 65 million housing units per year were needed to replace existing housing stock that was unusable.

Since vacancies are so expensive, you should do everything you can to keep tenants. Even a tenant that's not paying in a timely manner, but is trying diligently, should be worked with as much as possible. Communication is the key. If the tenant is communicating with me on their own volition, then I am much more agreeable to cutting them some slack. But, if I don't hear from them, and I have to make phone calls and go by the property, then I'm not a happy landlord. And, I let them know it.

10. MAINTENANCE

Investing in real estate can be a scary thing. Many people comment that they don't want to fix a toilet or deal with a tenant's problems. I've been a real estate investor for 20 years and have never once repaired a toilet. I don't know how and don't want to learn.

I look at real estate as a commodity and a cash flow machine. Now it is true you can save some money doing your own repairs and property management, but you don't have to do that to make investment real estate work for you.

A professional property manager can handle all those headaches for you and send you a check each month. Additionally, handymen are numerous and can definitely help in the day-to-day toilet explosions and tenant issues.

The bottom line is you don't have to fix toilets to own real estate. Spend your time looking for deals and not fixing toilets. Leave that to the guy with the tools.

One possible problem new investors need to watch for is spending too much money on maintenance. Yes, I know, you don't want to be one of those absentee landlords. Grass unmowed; weeds in the beds; junked cars in the yard. But, you have to learn what maintenance is okay to defer (called deferred maintenance). In general, here's my list of things to spend money on:

1. **Keeping the building dry**. Fix roof leaks. Fix plumbing leaks. I once bought a duplex for one third its value… about $40,000. The owner had let a roof leak next to the chimney (the most common location for leaks) for several years until it rotted the floor. The subfloor had dropped almost two feet and no one could live in the place. I picked it up for a song because the landlord couldn't deal with the issue. A small leak that would have cost maybe two hundred dollars to repair ended up costing him well over $100,000 and loss of rent of around $700 per month over several years.

I spent about $30,000 on the repair and started renting the unit immediately. Now, I have over $30,000 in equity in the building and make close to $1,000 per month off of both units combined. What a dumb landlord!

2. **Keep the grass mowed or make your tenant do it.** If your tenant won't keep the grass mowed and beds weeded, you've got to do this. Build it into the rent. Neglecting this will give your tenant the signal that you don't care about the property… so why should they? It will lead to vandalism from other people, cigarette butts on the ground, trash in the yard, and other malfeasances.

3. **Tow off old cars and throw away junk**. Have a clean up day about once a quarter. Find a tow company in your town that will tow vehicles with just a phone call from you. Most of them will tow off the car at no cost to you. Rent a dumpster if you need to and hire a day laborer to de-junk the area.

4. **New carpet and vinyl.** If you have to, change out the carpet... but don't be too quick on this one. For less than a hundred dollars, a professional cleaning company can do wonders. Make sure they can use heat and can remove stains. Most carpet will stay looking pretty good for a couple of months after cleaning.

5. **Repaint the interior often**. It's the cheapest way to freshen up a property.

Don't spend money on:

1. **New carpet and vinyl.** I put this one in both categories, because most newbie investors change out carpet and vinyl unnecessarily. If carpet is frayed, then change it. Carpet can be re-stretched and will look much better. If there's a bad stain, have the carpet company patch a spot from a closet, or somewhere else that's hidden from view. If vinyl is torn, it can be repaired. Usually vinyl needs to be replaced if it becomes just way too dull and can't be brightened up.

2. **Landscaping.** Tenants don't appreciate it. Listen, I love landscaping. My undergraduate degree had some training in landscape architecture. But, don't spend money on something your tenants won't appreciate. Just make sure it looks neat… nothing fancy.

3. **Interior renovations.** Unless you're renting high end houses, leave the kitchen and bathrooms alone. It's rare that you'll get any more rent because of a renovation, unless it just looks terrible to begin with. By the way, kitchen counter tops can be painted and they will last for a couple of years. Also, bathtubs can be painted with a special paint also. You've got to use your judgment on these, but be careful.

4. **Don't paint exterior unless you have to.** Definitely, keep it clean with a pressure washer. You should probably repaint in most climates every six or seven years. A trick you might want to try is just repainting the front door or the trim on the house… sometimes you can get by with that.

In general, if you spend money on it, make sure it's a necessity to attract a tenant or keep a tenant – not just something you think would be "nice." Anything else is a waste of your money!

11. OVERSEEING CONTRACTORS

I recently had a plumbing problem. I reached my usual plumber and asked him to take a look at it. It seems the toilet was backing up into the shower when it was flushed… a sure sign of some big trouble. My plumber (actually one of his workers) called me on the phone and gave me an estimate of $2,000 to repair. It appeared that upon inspection with his camera, roots had invaded the old pipe and collapsed a portion of the sewer. After talking a few minutes on the phone, I asked if he'd be there long enough for me to swing by. Upon arrival, I took a look at the camera images to confirm what he was telling me.

We walked outside to look at the area that needed to be repaired. After getting acquainted for 10 or 15 minutes, "shooting the bull" as we call it in the South, he agreed to do the job for $1,300. That 15 minutes of getting to know the contractor and doing some face-to-face negotiating saved me $700. Ask for the discount. Most people find it hard to tell you no to your face. It's much easier for the contractor to stick to his price on the phone. (By the way, this is another way that a professional property manager would cost you money. There wouldn't be any face-to-face negotiation. The contractor would just be told to do the job.)

I have one caveat here, though. Don't become known as a "nickel and dimer." That is, if the contractor is someone that does a lot of work for you, don't negotiate every time, especially on the smaller projects. Save up your good will for the big projects. After all, if it's a small repair for $250, even a 10% reduction is only $25. It's hardly worth the contractor's time to negotiate on such a small deal. Also, if he knows to expect that you will negotiate on every job, then he's going to start out high so he can be where he wants to be at the end. Don't be a pain in the butt. Yes, you're the boss and you are doing the contractor a favor by hiring him instead of someone else. But, that kind of attitude will get you higher estimates than those customers who are friendly. Everyone likes to work with a friendly person. Be a friendly person and your contractor will enjoy the relationship. You'll need to strike a balance. Be known as someone who is tight with money, but fair.

Also, pay your contractors on time. One of the worst parts of being a self-employed contractor is wondering if you're going to be paid. If you're the kind that pays bills whenever you feel like it, be assured that your contractor is probably worried that he won't get paid. I usually try to pay right when the job is complete, especially on large jobs. If the contractor has to hunt you down for payment, then you can be assured his next estimate will be a little higher. The bottom line is, you're going to pay him anyway, so why not pay him quickly and reward his good work. It will cost you less in the long run.

Another benefit in paying your contractor promptly is that he will reciprocate by promptly fixing your problem. There's nothing that makes a tenant discontent quicker than an air conditioner that quits working when it's 100 degrees outside or when the toilet overflows into the bathtub. If you have a good relationship with your contractor, then he may move service calls for his less friendly customers to accommodate you. And, that can be valuable in tenant retention.

I do recommend keeping your contractors honest by bidding out their work every now and then. I would never fire my existing maintenance guy over a small difference in price. However, bidding out the occasional job, and making sure your usual contractor knows you are doing this, will keep his pencil sharp and his work up to par. I have gone through four or five maintenance guys during my mailbox money experience… mostly because they become lazy and the quality of their work becomes lower as they start to believe they are the "only game in town." However, my HVAC (heating and air conditioning) guy and my plumber have been with me for the duration. Their work continues to be of high quality and their pricing is always fair.

Hiring contractors is not just about getting the best price. It's about creating a long-term, mutually beneficial relationship. You don't need to be friends – and I wouldn't recommend being friends. Just keep it professional and business-like, but very friendly. Pay promptly. Review their work. Demand good service. And, you will be very happy with the results.

12. CONTROL THE RENT

I've turned down really good deals in areas of 50 or 60 duplexes before. Why? It's all market demand. Why buy a property next door to 50 properties that are the same size, same style, same number of bedrooms? Can you compete with that? You can't compete with a guy that bought his property 10 years earlier and has a mortgage of $300 less per month. If he lowers his rent by $100 per month, then you have to also. There's nothing you can offer that he can't. This is bad news.

Now, what I've done before is focus on a small street of properties. I slowly bought all the properties on the street to control the rent. Since I own all of them on the street, I decide what the rent is, not my direct (next door) competition.

Houses are obviously a little different. The reason is that in most subdivisions, most of the houses are owner occupied. They're not all being rented. While you may have a little competition on the street, you most likely won't have the guys on both sides of you and across the street with the same floor plan. It's harder for him to compete with you. Also, houses are usually quite different. A street of duplexes, triplexes, quadraplexes, and apartments are usually virtually the same. Same number of bedrooms, baths, and same look and feel.

CHAPTER TEN – FINANCING

There are generally two types of loans: fixed-rate loans and variable-rate loans. Fixed-rate loans will not vary over time. Their interest rates are "fixed," hence the name. Variable rates are indexed to fluctuate relative to a market value of some specified benchmark. Their rates generally start out low as a teaser, then adjust upwards as the loan matures.

Loan term is the period of time which the loan is outstanding. This shouldn't be confused with amortization. Loan term refers to the period in which the loan must be repaid. Sometimes the loan term and amortization is the same. Typically, if you buy a house, you get a 30-year amortization with a 30-year loan – which means if you pay the prescribed monthly payment every month for 30 years then the loan is paid off. But frequently, especially if you have a variable loan, it might have a 30-year amortization with a 5-year term (or balloon payment). This means your mortgage will be the same on a monthly basis as if you would pay it off in 30 years, but the bank is requiring it to be "satisfied" or "paid off" in 5 years. In other words, this would require a lump sum payment at the end of the five years or you would have to refinance to pay off the note.

To a lender, a loan is an investment and the lender must achieve their investment objectives. One way of achieving a higher yield is to charge discount points for the loan. A discount point is a charge paid upon issuance of the loan equal to one percent of the loan. Purchase of a discount point will lower the interest rate on your loan. This is often allowed as an option to the borrower. If discount points are paid, then the lender is not loaning as much money – thus, increasing their yield on the loan. In other words, the less money the lender loans relative to the amount of the down payment, then the higher the yield to the lender. This change in return on the lender's investment is called the effective interest rate. The stated interest rate is called the nominal rate; and the effective interest rate is usually higher than this. The one significant advantage of paying discount points is that the costs are deductible. However, it usually takes around 6 to 7 years to benefit the difference on the interest rate reduction. Most investors, prefer to save the capital and not purchase discount points.

Interest rates for investors are not always what they seem, and that can work in your favor. Interest is a deductible expense for investment properties. Thus, interest costs are actually offset by the tax rate of the borrower. For instance, an interest rate of 6% will only costs a person in the 35% tax bracket 3.9%. For instance, on a $100,000 loan, 6% interest would cost you $6,000 per year. However, this interest would be deductible and would save you $2,100 a year in taxes at 35%, thus, decreasing your actual out of pocket expense to $3,900, which equates to 3.9%.

This tax advantage is another benefit of using financing. In a real estate market where properties are appreciating by 3 to 4 percent, then the costs of funds relative to appreciation is zero. As in the previous example, your $100,000 unit is increasing in value by $3,000 to $4,000 per year, and the interest only costs you $3,000 to $4,000 per year. So, owning the property costs you nothing from an interest standpoint.

CHAPTER ELEVEN – APPRAISALS

Appraisals are an art form, not science. While appraisers are well trained professionals, their opinions are really just that, opinions. As I've said before, the buyer decides the value, no one else. Many a person has been duped by unscrupulous sellers using doctored appraisals to support inflated values. Beware of this and make sure that you do some independent research.

However, since someone has to put a finger on value for lenders, we have to look to the appraiser's opinion for an idea of what the value is. There are three main types of appraisal methods: cost approach, sales approach, and income approach (my favorite).

The cost approach is a simple method that estimates the total cost to build the structure and site improvements on the same lot. In the case of a house, the appraiser takes the price to build the house just like it is and adds the cost of the lot and site improvements. From that, the appraiser will deduct the depreciation of the existing house because it is older. This will give the appraiser a cost approach value.

Another method is the sales approach. The appraiser will attempt to find similar properties that have sold as recently and as close to the subject property as possible. If there are differences in the comparables, such as one less bathroom, the appraiser will deduct this from the value of the subject property. Or, if the lot is smaller or larger, he will make an adjustment in the value. Eventually, after making his best guess on value adjustments, he will reach a sales approach value.

The other method, which I prefer, is the income approach. This approach is less open to subjectivity than any other method. As we discussed in an earlier chapter, the value is derived strictly from the amount of rent that can be achieved. Based upon this income and some common valuation methods, the appraiser will reach a value based on the income approach.

While all three methods have their advantages, I prefer the income approach and cost approach, since they are less open to subjectivity and "irrational exuberance" in the market place. Sometimes, buyers become emotional or greedy in hopes of quick profits. These sales can push delicate market values to the brink when the sales approach is used consistently. Many beach condo owners along the Gulf of Mexico fell prey to this appraisal method in 2006 and 2007. Prices sky rocketed as condos were traded like hot stocks in hopes that another sucker would come along. For a while, it worked, as appraisals were completed showing values increasing faster and faster. However, the bottom finally dropped out as the pricing outstripped the income and cost approaches. Had investors been more cognizant of these other two valuation methods, many would not have jumped into the market and lost so much money.

CHAPTER TWELVE – TAXES

TAX IMPACT

Real estate is one of the best, if not THE best, tax shelters available. The term "tax shelter" has some negative connotations, because of frequent misuse of the term. However, tax shelters are legal methods that allow you to reduce your tax burden. Real estate is a legally permissible tax shelter that you can use to offset your personal income taxes. The primary tax shelter for real estate used to be called depreciation by the IRS, but is now referred to as "cost recovery." I'll use depreciation since it's an easier term to use.

The beauty of depreciation is that while your real estate investment is actually appreciating, the federal government allows you to pretend that it's depreciating in value. Residential and commercial real estate is treated differently for depreciation purposes. Residential property is depreciated over 27 ½ years and commercial property is depreciated over 39 years.

For an easy example, let's look at a rental house that's worth $100,000. Since land doesn't depreciate, we only consider the value of structures on the property. So, in this example, the actual house may be worth only $80,000 and the land is worth $20,000. So, you simply divide $80,000 by 27 1/2. This comes to an amount of $2,909 per year of depreciation value. This is to say that the IRS assumes that the building depreciates the same amount every year for the next 27 ½ years, an amount of $2,909. This amount comes off of your adjusted gross income.

Now, since tax deductions are dependent upon current tax code and your amount of income, this amount of depreciation will affect different people in different ways. If you are in the 36% tax bracket, then in this example, your taxes would be reduced by $1,047 per year. ($2,909 x 36%).

Unfortunately, you aren't allowed to depreciate your primary residence. You're only allowed to depreciate property held as an investment.

In determining what value to depreciate on your property, the IRS gives some leeway. Since you can't depreciate the land, then you must determine what the value of the structures are, so you can use this to determine the depreciation. I think the safest way is to get a copy of your county tax records. The county will have a value of the land and a value of the structures on the property. You can use the county's records to back up your depreciation amount.

In this example, if the property is worth $100,000, then normally your land will be worth around 20% of that and the structures (which you would depreciate) would be worth $80,000. However, you can use whatever values you deem reasonable and can back up with some data and research. Your particular tax situation will determine how you want to tackle this issue.

TAX CLASSIFICATIONS

In real estate, the ownership of the property affects who pays the taxes. For the private investor (non-institutional), there are two main types of ownership: taxable entities and pass-through entities. Taxable entities, such as individuals, sole proprietorships, and corporations, must pay taxes on the income that their investments generate. Taxes are computed differently depending upon the owner's tax situation. Pass through entities are called this because the tax liability passes through to the owners. The actual entity is not taxed for income generated from the investment. For instance, general partnership tax liabilities are passed through the business entity and to each partner. Each partner, then, is responsible for payment of taxes on their portion of the income.

TAXABLE INCOME

Income generated from a real estate investment can be divided into two types: cash flow and taxable income. These two rarely are the same. Cash flow is the money that you put in your pocket after paying all your expenses, such as mortgage debt, property taxes, insurance, and maintenance costs. Taxable income is the amount of this cash flow that you pay taxes on. From the cash flow, you would deduct expenses such as depreciation and interest paid, to calculate the taxable income. The tax sheltering benefits of real estate become evident when comparing the cash flow you put in your pocket with the amount the IRS requires you to acknowledge for tax purposes. This difference is what will make you much richer in the long run.

ADJUSTED BASIS

You may have heard the term "adjusted basis" before. It's important to understand a little about this term and the consequences of how maintenance, repair, and capital expenditures will affect your real estate someday.

The basis of your property is a benchmark value that is used to determine depreciation and eventually how much tax you will pay when you sell the property.

It's easy to think that since these are accounting terms that it's something you shouldn't be concerned with. But, I can tell you firsthand that you at least need to understand the concepts. You can let your accountant worry about the details.

The "original basis" is used for tax purposes to determine the gain or loss when you sell the property and amortization deductions. The basis for the property is determined by the method of acquisition. If you inherit the property, then your basis becomes the market value of the property at the time of the bequeathal. A gift of property will set your basis at the donor's basis plus any gift tax adjustments. If you purchase the property, then your basis will equal your total purchase price. And if you have used the 1031 exchange (which I'll cover later in the book) to purchase your property, then you will have a substitute basis that will be calculated based on your previous property basis.

TO CHEAT OR NOT TO CHEAT

Diane (name changed to protect the guilty) was a client of mine who initially worked her way onto my email tree several years before. I had sent out an email with an apartment complex for sale, and she called to ask a few questions. After we spoke a few minutes, she indicated that she had 20 units of quadraplexes she was interesting in selling. So, I went out to take a look at them, and we agreed on a listing price.

Andy was a friend of mine who had been pondering becoming a real estate investor for quite a few years. He was a novice, but he had a great work ethic, W-2 income (which banks love), good people skills, and some extra cash. He would make a great hands-on landlord and he had asked me to help him located some multi-family properties.

I pounced on this deal for my friend Andy, because it was the right deal for him. So, the next day I took Andy out to look at the property. He liked the property, and after doing a little research, he made an offer the next week.

Andy and I then talked with a mortgage guy and got Diane's profit and loss statements for the prior three years – and that's where the trouble started. Diane didn't grasp the difference between capital expenditures and normal operating costs (or maintenance). So, to "save" money on taxes, she included all of her capital expenditures, such as new roofs, new appliances, and new carpeting, as normal operating costs.

Why did this make a difference? Well, the net operating income (NOI) was reduced due to this accounting mistake. For instance, let's say the NOI that she reported to the IRS was $200,000 per year. But, $30,000 should have been reported as capital expenditures, which would have been depreciated over some time period. Instead she took this off the top of the net operating income (NOI). She did this because it decreased her taxes. But, it bit her in the butt, later. Why?

Because, using a capitalization rate (the return on the investment if you paid cash) of 10%, as we covered in a previous chapter, her value would be $2,000,0000 based on her reported IRS numbers. However, had she properly accounted for those items, then her NOI, would have been $230,000, yielding her a value of $2,300,000 – a $300,000 difference. That's a huge difference! Probably a hundred times what she saved in taxes. Now, that's "penny wise and pound foolish."

The trouble was she was trying to sell it for $2,300,000, and the bank couldn't value it at that because of her erroneous IRS reporting. The bank could only value it at $2,000,000. Andy wanted the property, and understood it was worth what she was asking; but he had to walk away from the deal. No financing, no deal. Cheat on your taxes and it gets you in the end.

BASIS

Basis is calculated by determining the value of the property including transaction costs and commissions paid by the person that is buying the property. During the course of owning the property, your basis will be "adjusted" and will become known as the "adjusted basis". This is where certain capital improvements, such as new roofs and new appliances, are added. Maintenance and repairs are NOT considered to be capital improvements.

The "basis" must be allocated between land, improvements, and personal property. The reason for this is that improvements and personal property are the only ones subject to depreciation. Land is not. Personal property, such as furniture, computers, and appliances are depreciated on a shorter time period because they obviously don't last as long as other improvements.

While this might get too complicated for most of us, you can use whatever reasonable allocation that you want. Of course, I find the best way is to understand the concepts, but let the professionals deal with the details.

CAPITAL GAINS TAXATION

Capital gains tax directly affects your exit strategy, and it's something that you must understand prior to selling a property. If you sell property that has been used as income producing, then you will owe what is called "capital gains tax." The tax can be divided into two categories:

1. Depreciation deductions – 100% of the amount you deducted for depreciation while you owned it, will be taxed at 25%. Deprecation reduces your taxable income while you own it. However, depreciation reduces your "basis" in the property; and therefore, increases the gain on the sale by an equal amount.

2. Gain from appreciation – 100% of the amount is taxed up to a maximum of 20%.

If this tax bothers you, as most taxes bother me, then you need to know that the IRS has created a way around paying it. It's called a 1031 exchange, like-kind exchange, or Starker exchange. The 1031 comes from the section of the IRS code that allows you to defer capital gains. In 1970, a family named Starker challenged the IRS's ruling on capital gains and eventually won the court case against the IRS. A 1031 exchange merely allows you to swap properties without actually swapping the property. When you sell an investment property, IRS rules will allow you to purchase a "like" property, of equal or greater value, and defer the capital gains into the new property. A third party company, known as an exchange intermediary, that's approved by the IRS, will hold your funds from the sale of the first property until you are able to close on the second property.

If done properly, this "exchange" will allow you to defer the capital gains until the sale, or another exchange, of this second property. It is possible, upon your death, to bequeath the property, and your heirs will not have to pay capital gains either. In effect, through the use of the 1031 exchange, it is possible never to pay capital gains in your lifetime. Who says you can't cheat the taxman?

While you may do whatever you can to avoid paying this tax, you will probably need to do the math to see if it actually makes sense. Right now, capital gains tax is 15%. Depending upon your tax situation, it may make sense to bite the bullet and pay the tax anyway. Of course, the exchange intermediary will bill you for their time. And, there's no way around this cost. I have done both. I've had properties that I had huge capital expenditures on; but after calculating the intermediary's fees, I decided it best to just pay the tax and move on. Other properties have had a sizable capital gains tax, so I preferred to defer the capital gains by purchasing another property.

One thing to keep in mind is that there is a time limit on finding a property to purchase. Many investors have made dumb mistakes because of this time limit. They purchase something that is overpriced, or they buy a property without performing proper due diligence. Many sellers salivate when they hear that a 1031 investor is looking at their property. They know that someone under a time crunch and determined not to pay a capital gains tax will do some pretty dumb stuff.

If you happen to be one of those investors, never let the seller know it – under any circumstances. If you must tell your realtor, then expressly forbid them (in writing if necessary) from relaying this information to the buyer. Let them know that they will be fired on the spot if this information leaks out. And, always remember that most sales people have big mouths!

If the seller catches wind of your impending deadline, they will have the upper hand in negotiations, and it will cost you money in the end.

CHAPTER THIRTEEN - IDENTIFYING PROPERTIES TO PURCHASE

I've found properties to purchase in numerous ways over the years. My favorite way is to dig through the newspaper and look for tired landlords. I usually use a local paper, not a regional paper, because I like the people that advertise there. They tend to be "mom and pop" operations, as opposed to property managers trying to push a bunch of properties.

I check out the For Rent classifieds in the section that I'm wanting to buy. Obviously, you can look at the "For Sale" ads, but there won't normally be many of these. They tend to cash flow nicely and rarely go "on the market." If I'm looking to purchase a duplex, I normally will call on every "For Rent" ad in the paper for duplexes. You can also call on "For Rent" signs you see on the road, as well. Call the landlord and strike up a conversation with them about the property and rentals in the area. Most landlords will be very open if you are upfront about what you are up to. Ask them about vacancy rates, how easy it is to rent once vacant, local zoning laws, local eviction laws, local maintenance property codes, etc. Toward the end of the conversation you will normally get an idea whether this landlord would be willing to sell the property. Now is the time to ask.

I've bought several properties like this. I found a really nice two story duplex this way. The owner was a residential mortgage broker and we struck a good conversation on the phone. He agreed to meet me at the property, and of course I had a contract ready for his signature. After getting acquainted with him at the property, we agreed on a price.

Since I'm a real estate broker, I didn't need to hire a broker to help me on this purchase (although I have done this on occasion depending upon the deal). This has been a huge advantage to me. On this deal, I was able to add a seven percent real estate commission on the deal, payable to my company. So, at closing I signed over the corporate commission to the lender and put down just 3% on the purchase. A look at the numbers will tell you why I did this deal and would do a thousand of them if I could. The duplex costs $135,000, including commissions. After putting in a 10% down payment (remember 7% of it is financed and did not come out of my pocket), the mortgage was $918 per month including taxes and insurance.

Each side rented for $800,which equated to $8,184 cash flow per year after paying the mortgage, taxes and insurance. Now, remember my 3% down payment was only $4,050…which means I doubled my money in the first year. That's a 200% return on my initial investment! To this day, that seller, who's become a friend of mine, tells me he shouldn't have sold the duplex. It was a cash flow machine and I just happened to catch him on a day when he was tired of dealing with some issue. This is my favorite way of buying a property because the buyer controls the deal. There's no intermediary (realtor) that helps set an artificial value and sometimes sets the seller's expectations too high just to get the listing. It's just you and the seller, going at it head to head. It's the art of the deal. I make a huge return on my investment, even though a lot of people won't believe the numbers. I probably wouldn't believe it if I hadn't done it myself. And, I've done this on at least seven different properties with the same kind of returns.

I've also found several deals just by talking real estate to anybody and everybody that wanted to. You'd be surprised how many people love to talk about real estate. It's something almost everyone has an opinion on… after all, everyone lives somewhere.

One deal in particular was a two story building in a small town where I used to hold a 9 to 5 job. As I was waiting on a client to show them a property across the highway, I noticed an older gentlemen working on a front door lock on a two story building mixed in with small office buildings. Having an hour to kill, I decided to talk with the guy just to see what was going on. After introducing myself, I explained that I was trying to sell the property for a client across the street. His immediate response was "why don't you buy this one?" I wasn't really in the market, but after talking a few minutes, I struck up a whopper of a deal. He agreed to sell it for the tax assessment; which I believed was well below market value. And, he even agreed to do owner financing on the deal with just a small down payment. This was a prime example of how just talking real estate leads to some good deals.

Another deal I found was after reading, *Think and Grow Rich,* by Napoleon Hill. One key point that I picked up from the book was to think and act differently than you have in the past. So, one morning as I was traveling to work, I noticed a gentleman mowing a yard of a house next to the local high school and across from the Post Office. This was in the fastest growing county in the nation.

I recalled the admonition in the book and realized that I had driven by this little house for five years and had never pondered that it might be a good investment.

I quickly made a u-turn and stopped to talk to the gentlemen. Upon further inspection of the house, I had the idea that it would make a great office. After jotting down the owner's telephone numbers, I started my research. I contacted the local city council member that was in charge of that area and found out that he agreed that it would be a great location for an office. I checked the future land use plan and discovered that it indicated a future office use. All signs pointed that it would be a slam dunk zoning change for an office. It had great traffic flow, was on a road that was about to be four-laned, and was across from the only post office in the fastest growing county in the nation. The only problem was, I had no money and the guy wouldn't sell the property subject to me getting it rezoned. So, I had a dilemma. But, continuing the thought from the book of thinking outside my "normal," I called a friend of mine who had been in the real estate business for a while. He agreed to partner with me on the deal for half of the profit. In exchange, he would put up the down payment. The seller agreed to do owner financing with 10% down, and we purchased the property.

Despite the fact that I wanted to rezone the property, the owner wouldn't sell contingent upon this. So, we bought the property anyway, knowing that it still would create positive cash flow as a residence. After a few months, much to our relief, we were able to rezone the property. We continued to rent the house as a residence, while we marketed the property as an office.

A few years later, we sold the office for twice what we paid and each pocketed $50,000. Not a bad pay day for seeing the potential of a house I had driven by twice a day, five days a week, for five years. If you want to be a good investor, you must think differently than you do now. We should always be changing our perspective. Question what you do everyday. Is there a property you've just driven past without thinking of the possibilities?

REAL ESTATE AGENTS

I have also found quite a few properties through other real estate agents. Some people get greedy when it comes to working with agents. They think that if an agent makes money off the deal, it's costing them money. If you're one of these kinds of people, then it's time to get a clue. I know I'm biased because I'm a licensed broker, but I've put my money where my mouth is. And you should change your ways in this regard for two reasons:

1. **Agents are good at what they do.**

   Agents are on the front line of real estate deals. No one has a better handle on the real estate community than a go-getter agent who eats, lives and breathes real estate. A good agent sees more real estate in a day than you will see in a month. They make it their business to talk to lawyers, mortgage brokers, and others who have leads. Befriend an agent and you will find better deals than doing it on your own.

   I have bought two properties from one particular agent, Kacy Lewis. Kacy is on the ball and is a go-getter. One deal in particular that she brought me was a house in bankruptcy. The house had some termite damage and some other renovation work to be completed. She called me one morning about 9 o'clock and told me I needed to get to the house by noon to make an offer in order to meet a court ordered deadline.

I met her within two hours and had her write the offer on the spot. I bought a house valued at $165,000 for $95,000 and put about $5,000 into the project. This house continues to provide great income to this day. I made sure Kacy made her full commission on the deal and I made sure that I was easy to work with. She needed someone who could react quickly and not give her any problems. I was the guy for the job.

2. **You'll never get another deal if you stiff one.**

I make sure that any agent who brings me a deal gets their full commission. Never, and I mean NEVER, try to cheat an agent out of a commission. I have had people do this to me and I NEVER take them another deal. Even if they complain about my commission in the least bit, I NEVER take them another deal. There are hundreds of buyers out there who will jump on a "steal of a deal." You're not the only game in town partner. The slam dunk deals are easy to sell, so I'll take the "steals" to someone who is friendly, easy to work with, and doesn't mind if I make some money to. It's just human nature and common sense. Be greedy and a good agent will take his ball and go to another ball park.

A few years ago, a friend I'll call Jim was in the market for residential development deals. Jim and I had been friends since college and had graduated together. Twenty years later, Jim was looking to develop a subdivision and was asking me for help. The deal was a decent raw land deal and had a sizable commission for me. Jim couldn't get past this issue. Jim, who had strong opinions about things, commenced to telling me that real estate agents in general were overpaid. After a thirty minute tirade of his displeasure, I made a decision. I would never take him another deal. I couldn't afford to. I couldn't afford to bring him a deal because a lot of deals (especially really good ones) are unwritten hand shake agreements between me and an owner. I have nothing to protect my commission but trust of the parties involved. If I know Jim is stewing the whole time that I'm making too much money, then I'm concerned that he's thinking of ways to beat me out of the money… and he probably is.

He has missed out on several even better deals than the original one… deals that would have made him twenty times what I would have made. Remember the old saying, "Pigs get fat, hogs get slaughtered." Be a pig and not a Jim.

WOULD YOU LIVE THERE?

For most investors, this is a tough one. Don't buy an investment property that you wouldn't live in. Think back to the days of when you first got started in your career… when you ate Raman Noodles to make ends meet, your car was twelve years old and you used free antennae instead of cable TV. Admittedly, your standards for housing back then, probably don't compare to what you want to have now. If you wouldn't have lived in the property back then, then you should probably shy away from it now.

Now, this doesn't mean that the property should be as "nice" as where you live now. It simply means that it should be clean, neat, and safe to live in. After all, this is a business for you. It's not to win a spread in Southern Living magazine or to get a spot on the Home and Garden network. You're trying to make money. Keep this in mind. Don't dream of your tenant running through the field, arms open wide, to give you a hug for providing the most beautiful house they've ever lived in… complete with warm melting chocolate chip cookies in the oven and fresh cut flowers on the kitchen table. It's not going to happen. Your tenant just wants what you promised in the beginning… a roof over their head, reasonably nice accommodations and reasonable rent.

TIPS FOR BUYING A SINGLE FAMILY HOUSE

1. The house should not be up a hill or down a hill. If the driveway is steep either way, stay clear of it. It is best for the house to be above the level of the street. Five to six feet is ideal.

2. Buy a house that has curb appeal, or give it curb appeal. Sometimes, it just needs a coat of paint or landscaping. But, be careful and stay away from houses with architecture that can't be changed without major costs. Make sure that you would want to live there. If you wouldn't live there then it's likely that your pool of tenant candidates will be decreased.

3. The house must be easy to find. Two to three turns maximum to reach the house from a main road. Any more and your potential tenant will get bored looking for it. I know it sounds strange. But, the easier the house is to find the easier it is to find tenants.

CHAPTER FOURTEEN - TITLE HOLDING STRATEGIES

A major decision when purchasing real estate is deciding how to title the property. There are two major classifications of ownership: corporate and individual. The selection of which ownership entity you use is a function of federal tax law and your individual liability risk. If a single owner acquires the real estate, then the title may be held as a sole proprietorship or in a corporation. My favorite way of titling real estate is in a limited liability company (LLC).

Under the LLC, owners have the liability protection of a corporation. Unless you've signed a personal guarantee, you cannot be held personably liable for debts. However, even a personal guarantee doesn't affect your civil liability. Assuming you've operated the LLC properly, then all you can lose is the LLC's assets, not your personal assets. This is good stuff and it is why I own most real estate in a separate LLC, or only keep a few properties titled to each one.

In this litigious society, we must always try to protect our assets. Protection of your assets doesn't mean you are hiding from responsibility or trying to get free reign to treat people poorly. It simply means that you may at some point face an unscrupulous tenant who thinks they may have hit "pay dirt." So, protect yourself from these types of people. Hire good attorneys and do your homework.

CHAPTER FIFTEEN – DUE DILIGENCE

Due diligence is the period of time when you have a property under contract where you will begin to investigate and research the property. Once you have identified a property you'd like to buy, the hard work really begins. There are three major criteria that you need to research during this "due diligence period."

ZONING

Zoning is the body of law that encompasses the rights and privileges granted by a local jurisdiction for the legally allowed use of the property. Many problems can be created and many problems can be solved with zoning.

As a former zoning administrator for 12 years in two different jurisdictions near Atlanta, Georgia, I've seen the benefits and the damages zoning laws can produce. As a believer in reduced government control, I view zoning as a "necessary evil." As a landlord, you will probably come around to this view as well.

As an investor, I prefer to purchase property that is in an area with strong zoning regulations for several reasons:

1. Strict zoning laws help maintain property values**.** I personally have purchased properties in a jurisdiction that is known for strong code enforcement, specifically, Alpharetta, Georgia, a suburb of Atlanta. As a conscientious landlord, your worst enemy will be those landlords who allow the neighborhood to run down. If the grass gets too tall, or the neighborhood is scattered with broken windows, or junked cars scatter the road, a good code enforcement officer will help remedy the problem. Of course, some of your property will be in neighborhoods with a homeowner's association (HOA). While they can affect the same outcome as a code enforcement officer, their process is much slower and cumbersome. A code enforcement officer can normally see a problem, knock on the door, and the problem is resolved in a few days.

HOA's have to write letters and beg and plead to have problems corrected. And, depending upon state law, many HOA's can only lien the property for failure to comply with a neighborhood rule. The HOA is usually not even allowed to actually correct the problem. A code enforcement officer can; in many cases, take the person to a local court, similar to a magistrates court and require a clean up. Some jurisdictions have the right to hire contractors to do the clean up and then the property is liened by the jurisdiction for payment. Other remedies include hefty daily fines until the problem is fixed. The result is much faster resolution of the problem. The power of government can be much stronger than the power of the HOA.

An effective code enforcement officer is like having your own maintenance man running around with a gun and badge requiring your tenants to keep the place clean. That's a valuable service that I take advantage of anytime I can. One particular code enforcement officer that I know has been a huge asset to me as a landlord. He keeps an eye on the neighborhood and keeps it cleaned up. An occasional phone call from him about a maintenance issue will also get me off my duff and calling the tenant to get the problem corrected. Befriend your local code enforcement guy and he will be a valuable asset for you in your constant battle against maintenance problems.

2. Strong zoning laws tend to regulate the supply and demand market cycles. A community with strong zoning laws usually has a lot of obstacles for developers to overcome in order to start a development. As a developer, I obviously haven't liked this part of government control. But, as an investor of existing units, it helps to protect the status quo. That government control decreases your competition by increasing what we call "barriers to entry." The jurisdiction will require numerous public meetings, require ad nauseum permitting meetings, and will generally put the developer through a hair-pulling-out process after process before he can build more units. It is this slow process that makes it hard to develop in most communities; and this slow process will be to your advantage as an owner of existing rental units.

ZONING RESEARCH

Zoning research needs to be subdivided in two categories:

1. Existing zoning laws. Do existing zoning laws allow you to do what you want with the property? Here's a word to the wise. Don't just pick up the phone and call the local jurisdiction to ask a question. Take it from an insider. I can tell you there's a lot of misinformation, sometimes purposely, that is given out to the public. For instance, I recently purchased a building lot and had a mobile home that I wanted to put on the property. The mobile home was a small 45' mobile home in pretty good shape that was built in 1983. I went to the county where I was putting the mobile home in order to purchase a permit. As I'm applying for the permit, the county planner looks over my application with a critical eye. "Oh, sir, you can't move this mobile home into the county because it was built before 1988." Now, I knew she was wrong – the date was actually 1979. I had done my homework prior to filling out the application. So, I replied that I thought that she was incorrect. With a very sharp tone, she advised me that she wasn't and that she wouldn't process my application. So, what to do? I don't know if she purposely told me the wrong information or if it was a simple mistake. But, I had to leave and come back when someone else was manning the permit window. I eventually got my permit and moved the mobile home onto the property.

   The bottom line is that you have to know the zoning code better than the planners. It's a lot of work, but it can cost you a lot of money if you don't. I know you shouldn't have to. People should do their job, but sometimes they don't. You have to be proactive to make sure that you protect your interests.

   Not long after I left one of the local zoning jurisdictions to start my commercial real estate company, I received a call from a real estate agent with interest in one of my listings that was in the same jurisdiction. She wanted to know the zoning on the property and she wanted to know if a restaurant would be allowed on the property. I assured her that the existing zoning did allow the restaurant. After a few days of not hearing from her, I made a follow-up call to see if we could make a deal happen. The deal was dead in her opinion, because she had called the zoning department and one of the planners told her that a restaurant wouldn't be allowed. I assured her that was incorrect.

She continued to argue with me until I insisted that I was right because I had helped write the zoning code in question. I sent her a copy of the appropriate section of the code to prove that her client could operate a restaurant in our building. She finally believed me, but the misinformation probably cost us a deal. Her client had found somewhere else that he liked better and our window of opportunity had been closed.

Your existing zoning research should include checking all laws pertaining to your property. This is usually in the form of one book that you can purchase or find on the jurisdiction's website. It is important to keep a copy of this book. It would be even better to have the copy certified and dated by someone in the local government… sometimes this is the city clerk, the mayor, a commissioner, or the jurisdiction's attorney. The reason you should keep a copy is to have evidence of any "non-conforming use" status, which is sometimes called "grandfather status." Jurisdictions change laws all the time; and most of the time, if your use is legal, then any subsequent changes to the zoning law would provide a clause that allows you to continue that use. This is what is referred to as "grandfather status." You must keep this in mind and keep documentation of it. Know the zoning law. Know your rights. And document both.

I recently purchased a building in a small town. The property is zoned for office use. However, it had been used since its construction as a residence. At some point in time, the zoning was changed (prior to my purchase) to allow for offices, not residential. However, since my property had been continuously used as a residence, then my residential use was considered to be "grandfathered." In order to protect my rights to continue to rent it as a residence, I must understand the zoning laws pertaining to this.

2. Future land use. Most jurisdictions have comprehensive land use plans that are updated every few years. In the State of Georgia, this is mandated by the state for most governments. Inside this document is usually a "future land use plan." This map shows each individual property in the jurisdiction and the future land use that the local government envisions for the property. I have purchased several properties simply because this plan shows that the future use is office or some other type of commercial development. The jurisdiction uses this plan to help guide them on future zoning changes. Perhaps your property is a small house on a major roadway that is transitioning from residential to commercial.

Even if it's still zoned for residential use, the future land use plan may indicate that it should be an office someday. This will give you great ammunition and some legal standing for a zoning change in the future, if you so desire.

If you want to get a leg up on future zoning changes for your property, then you should contact the government planning office to see when the next future land use plan change will be considered. Often, these meetings are much less controversial than the public hearings held for zoning changes. And while they are open to the public, they rarely draw much attention from the public. If you can make a case for it, the municipality may change the "future land use designation" on your property without much problem. This is the first step in the re-zoning process and often the government leaders welcome public input in this process.

INSPECTIONS

Once you have the property under contract, part of your due diligence process is to have the buildings inspected. This is a case of do as I say, not as I do. I have bought many properties over the years. At some point after buying probably twenty properties, I finally reached a point where I thought that I knew enough about construction that I didn't spend the money on inspections. I haven't been burned yet. But, I'm confident enough in my abilities that I'm willing to take the chance on what may be wrong with a building. Some of that experience comes from growing up around construction, doing several addition and major renovations and working next to building inspectors for about twelve years.

I'm also prepared that there will be certain problems inherent in the age of the properties that I am purchasing. However, I wouldn't advise that you follow my method unless you have some similar experience.

As a matter of fact, at one point I got way too lax with my inspections. A few years ago, I bought a two story duplex, about 2,400 square feet in a downtown area. I met the owner out front, talked with him about an hour and struck a deal on the property. We briefly walked through the property, but apparently I didn't do enough inspecting. About a year and a half later I had a vacancy in one of the units. Upon inspection of the unit, I discovered a bathroom upstairs that I didn't even know was there! I had even advertised the property as having one less bathroom. Although my inspection laziness didn't hurt me in this situation, it could have. And, I learned my lesson through this experience. Now, I am much more diligent during my due diligence.

LIFECYCLE

All real estate has a certain lifecycle. A Realtor friend of mine, Sara Benson, shared this analogy with me: The lifecycle of real estate is like the face of a clock. At 12:00 the property is born, at 3:00 it begins a growth cycle, at 6:00 stabilization, at 9:00 decline and blight, and rebirth at 12:00. A lifecycle may be around two or three years up to twenty years. Many urban areas go through multiple rebirthings. Figuring out where an area is in its lifecycle is extremely important. It's best to purchase property at the beginning of the growth cycle – 3:00.

Aerial maps of your investment area from years ago will show the growth that the area has undergone, indicating particular directions and along which specific paths real estate has grown. Within this area, land uses have probably changed from agricultural and residential to office, retail, and higher density residential. This is the natural progression of development and you should familiarize yourself with these trends. Your job as an investor will be to read these trends and understand how they affect your real estate.

Most American cities grew around transportation corridors, some even beginning from Native American trails and trading posts. Transportation plays a major role in community growth trends. For instance, rail transportation was the impetus for American city growth. Hence, most manufacturing activity was located around rail facility hubs.

Downtown locations were important for business because businesses had to be close together to conduct business. Before fax machines and email, the attorney's office had to be close to the accountant and real estate office out of necessity.

PHASES OF THE REAL ESTATE CYCLE

Failure to predict a city's growth cycle can result in disaster. For instance, Japanese investors in the 1980's poured huge amounts of money into U.S. real estate only to discover that they had purchased during the top of the cycle. Subsequently, they lost a huge amount of equity and capital.

On a local level, a friend of mine owned a 15,000 square-foot retail building on the northern boundary of a community with quickly changing demographics. It was surrounded by new car lots. But, the changing demographics didn't bode well for him. This particular demographic were not purchasers of new cars. Being a mostly low income immigrant class, they relied heavily upon mass transportation and inexpensive used cars. My friend, seeing this trend coming, put his property on the market to sell.

A local commercial real estate broker decided to buy the property. You would think he would understand demographic changes, but apparently he didn't. To make matters worse, he purchased the property about six months prior to the failure of several car companies (and subsequent federal bailout) in early 2009. Several of the car dealerships closed creating a wasteland of weeds and asphalt, right next door to where he was trying to attract retailers and restaurants. Subsequently, within a matter of six months the new owner had lost every tenant. He hasn't lost the property to foreclosure yet, but it appears that the demographics of the city have changed so much that he probably will.

Of course, that doesn't mean this property will be abandoned. Most likely the bank will write down the loss on the property until the value reaches equilibrium. This equilibrium will be determined by the prevailing market rents. And, those rents will be determined by the tenants that are eventually attracted to the area because of the demographics. The reduction in the rent, which I predict will be from 50-65%, will subsequently reduce the value of the property by the same amount. Failure to understand this lifecycle of cities leads to several people losing a lot of money, including the bank.

On a macro level, you can divide economic lifecycles of real estate into four sections: recession, recovery, expansion, and oversupply.

The first phase of the real estate cycle is recession. In this phase, sales activites are slow. Prices and rents continue to decline. Property values decline as market rents decline. While some areas will be hit severely, some may experience little downturn. Vacancy tends to move up tremendously. During this cycle, very little construction occurs.

The second phase is recovery, where the recessionary affects start to reverse. Rental prices begin to recover and vacant spaces start being absorbed, resulting in lower vacancy rates.

The third phase, expansion, follows recovery. Since no construction has occurred during the first two phases, construction begins to heat up dramatically. Rents begin to rise rapidly and development continues on a hurried pace to try to catch up with new demand.

The fourth phase, oversupply, is a natural result of unbridled expansion. Builders and developers continue to pump capital into the market, and seldom, are able to detect the dangerous changes occurring in the market. After all, most existing real estate is at or near full capacity, near historical low vacancy rates. Many projects continue during this cycle despite the warning signs. Some projects in the pipeline aren't stopped because they are partly under construction already. Stopping and starting back would not be advantageous to the developer or lenders. But, as the projects eventually come to a halt, the market begins to retract, vacancy rates move up and prices drop. The market has now moved back into the recession cycle; and the cycle continues as before.

CITY DEVELOPMENT THEORIES

CONCENTRIC CIRCLE THEORY

In the 1920's, Ernest Burgess, a geographer at the University of Chicago, proposed the concentric growth cycles of cities. The inner core was made of the Central Business District, where office buildings, department stores, and government offices are located. The second zone is the transition zone where manufacturing and low-income housing is located. The third and fourth areas are low income, middle and upper income residential areas. And, the fifth area is the commuter zone. Burgess's model said that wealthier people lived furthest away from the city center. As the city grows, the city center expands and the rings expand outward. This model assumes that physical and geographic restraints, such as mountain ranges or large bodies of water, wouldn't affect the growth. However, we know that such constraints will limit such growth. [1]*Market analysis for commercial investment real estate. Reference manual. CCIM Institute.*

SECTOR GROWTH THEORY

Homer Hoyt, another Chicago geographer, proposed that land developed according to cultural, economic and climatic factors, such as prevailing winds. He proposed that the growth occurred at the periphery rather than the center. [2] *Market analysis for commercial investment real estate. Reference manual. CCIM Institute.*

AXIAL GROWTH THEORY

This theory, proposed by Richard Hurd, indicated that development will follow along major highways and roadways. Travel time is the key to growth for this theory.

MULTIPLE NUCLEI THEORY

This theory is an outgrowth of the Axial theory. New urban centers, or satellite cities, grow along the ends of the transportation corridors. These urban centers become smaller central business districts, incorporating many of the same uses as the downtown urban centers. Locations of the satellite cities tend to be correlated with driving time to the major downtown urban center. [3] *Market analysis for commercial investment real estate. Reference manual. CCIM Institute.*

MY MODEL OF FUTURE CITY GROWTH

Future growth of cities may not be as dependent upon transportation due to the advancement of the Internet, cell phones, and remote working. It is my belief that cities will eventually be more of a social gathering experience rather than a necessity for business. Cities will become more much smaller hub-centered developments with a variety of uses for the enjoyment of the citizens. Most businesses will be able to operate virtually anywhere, with only retail and restaurants locating near residential areas for purposes of attracting customers. There will be an evening-out of downtown land prices compared to suburban land prices. In other words, adjusted for density, suburban land prices will rise, while downtown land prices will decrease. The reason that I mention density is that higher density is usually allowed in downtown markets… mostly because the transportation network can handle higher density and the downtown land prices are so high that they generally require a higher density to offset the land prices.

Employees and business owners will favor communities with lots of recreational and cultural amenities, less traffic headaches, and a stronger sense of community. The days of zoning laws requiring a separation of uses is over, or at least numbered. As the public begins to demand this type of community living, zoning laws will have to change to meet this demand. For too many years, zoning laws have produced the exact two things that the public dislikes the most: traffic congestion and sprawl.

Sprawl is the four letter word of city planning. Sprawl is the expansion of development that increases demand on transportation and services which are difficult to fund and properly deal with by encouraging development in fringe areas. This sprawl is often a by-product of zoning laws not allowing higher densities. The developer, not being able to build a product that is affordable to his target market, has to move where land prices are cheaper. Land prices are cheaper in the fringe areas – areas further away from the city center. So, his target market moves to the fringe area and drives into the city center, increasing traffic congestion, long commutes and pollution. If higher density were allowed closer into the city center, then the land costs per unit would be decreased, and the developer could provide affordable products for his target market.

The American public must begin to understand that there is a disconnect between what they want and what they say they want. Most developers that try to provide a higher density product with a mix of uses, such as housing, office, retail and restaurants, find strong, vigilant, and organized opposition from the public. I've been in many zoning hearings where the public was up in arms about projects that eventually were approved and were wildly successful. The "vocal locals" as I call them usually come out in force to intimidate the decision makers. While I agree sometimes the developer may need to be reigned in, we also must understand the capital real estate markets. The developer, hopefully, is providing something of value. If he doesn't, he'll go bankrupt.

Where does the public shop and dine and live? In these same city center projects that are eventually built in some communities. The public wants shorter commutes and wants to spend less time in their cars. It's time the public begins to understand city growth and understand themselves, because the public is what drives the market. If it weren't successful, developers wouldn't build it. The vocal minority needs to be less selfish and step aside for the good of the community and for the good of our cities. The supplier is just trying to meet the demand. Let them.

Understanding growth patterns is important to the real estate investor. By understanding future growth, you will understand the affects of this growth on the value of your real estate. Growth patterns will you help you understand the following:

1. Where wealth is moving
2. Where the population is moving
3. Where the land uses are changing
4. Trends in vacant land prices
5. Location and direction of major road construction
6. Location and direction of municipal services being added (especially sewer and water)
7. Zoning changes
8. Annexation activity
9. Building permits granted
10. Trends in neighborhood changes

[4]Market analysis for commercial investment real estate. Reference manual. CCIM Institute.

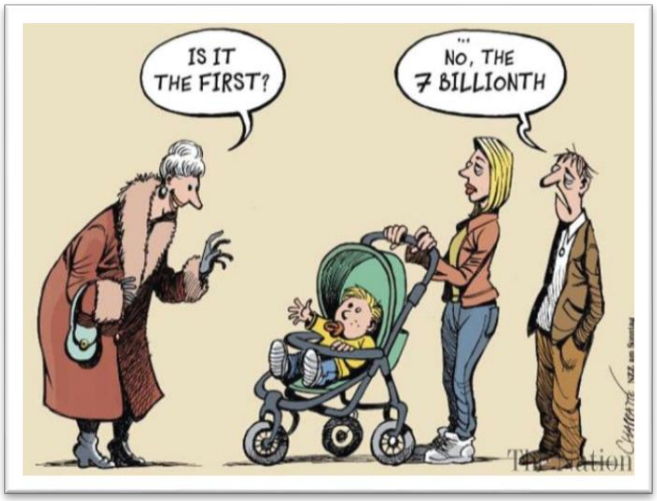
CHAPTER SIXTEEN – DEMOGRAPHICS

Demographics are an important part of buying investment property. You will need to research the population trends for the area. If you already live in the area, you will already understand some of these factors and how they affect housing prices and values. Population growth has the greatest impact on housing demand. There are four population elements that are of special importance:

1. Population growth
2. Age of population
3. Household population
4. Tenure

Population growth is made up of internal growth, in-migration, and out-migration. Internal growth is the growth generated within the community, such as children growing up in the community and needing households of their own. New employment creates in-migration and the loss of jobs contributes to out-migration.

Age of the population directly affects the demand for different types of units. Older persons generally want smaller units that are low maintenance. They prefer lots of amenities, want to be close to shopping and health care services, and want good security.



They may be open to renting, but want their costs relatively fixed. Younger populations generally want larger more expensive units and they prefer to own instead of rent because they want to build wealth for the future. They tend to more transient due to employment which requires them to rent more often than they would like. The location of employment and schools will be very important to them.

The number of people in a household determines the household population. In tough economic times, the size of households tends to increase, since people try to pool resources and save money. In better economic times, they tend to prefer their own housing, and housing units are in more demand. Follow these trends and you will be able to predict future housing trends. For instance, if the average household decreases while the population levels increase, then the demand for housing will increase.

Tenure is the term that refers to the length of time a person lives in a unit. Generally, multi-family housing will have shorter tenure tenants than single family, since the tenants tend to be more transient. To understand this will help you understand if the opportunities are in multi-family or single family housing.

CHAPTER SEVENTEEN - EXIT STRATEGY

Another factor for the investor to consider is the exit strategy, which is how to dispose of the investment when they are ready. Decide this before you buy. I know it sounds strange, but you've got to have some idea of how you will get rid of the property BEFORE you buy it. If you don't figure this one out, just prepare to hold it forever.

But, don't think that you will keep it forever. Most investors buy a property and think they will keep it long enough to bequeath to their children. But, few rarely do this. Most investment property is kept on average a total of seven years. Always assume you will sell it someday – because, you probably will.

The net worth investor who is buying single family homes will be selling his investment to a retail buyer. A retail buyer is someone looking to purchase the home to live in. This buyer market is generally fairly stable since there are a lot of them in the market place. Thus, it provides a little more liquidity for the net worth investor since the property is easier to sell. Additionally, this buyer may buy on emotion and doesn't care how well the house produced as a rental or what the investor paid for it. So, the investor, in a good market, can ask top dollar for the property no matter how well he managed it as a rental.

On the other hand, the cash flow investor is almost always selling to another investor. This may be an investor who bases his entire decision on the income of the property. The cash flow investor won't have the luxury of stretching the fair market value. The purchaser will only pay what the rents dictate.

So, while there are many opportunities in this new market cycle, potential investors must decide which route they want to take. Do they go with the direction of slow and steady and hope for a big pay day, or do they look to cash in the pocket today with less excitement in the end? These are questions that every investor, whether big or small, eventually must answer for themselves.

CHAPTER EIGHTEEN – CRYING AT THE CLOSING TABLE

Most of my days used to start with perusing the classified ads for tired landlords. When I first became an investor, I was low on cash and full of energy. So, my tastes were duplexes in small urban towns. I'd pour over the classifieds over a cup of coffee – calling each "For Rent" ad, trying to get an idea of the lay of the land, and finally popping the question if the owner had interest in selling.

I did this for one main reason: An owner who didn't have it listed could afford to pay a full commission, usually around seven percent. I'd use this as part of my down payment, kick in around three percent and, "Wham, I'm in the door."

So it started that I found a tired landlord with a "For Rent" ad in the newspaper. It was in a quaint little duplex neighborhood with only eight duplexes on the street, quick access to a major transportation corridor, and close to the small suburban downtown of Buford, Georgia.

After talking with the owner and doing some other research, my windshield value that I placed on each building, two units, was around $130,000. Being the negotiator that I am, I decided to start at a steal of a price of $90,000 each, for a total of $180,000 for both. The guy took my first offer… first clue.

Well, I was actually buying two identical duplexes, for a total of four units, from the same guy. And, the closing for both were planned for the same day. Closing day comes and I hitch a ride up the glass elevator of the expensive attorney's building, complete with leather chairs, free mints and filtered water. Sitting across from the seller, I learn that he was a happenstance landlord. He was a tenant of the property and his landlord wanted to get rid of the property. So, she worked out a deal to get him into the property for nothing and take over her headaches.

With his wife and newborn baby in tow, he beams about his plans to buy another property in their home state of Florida. He's proud of his investment prowess. His wife is proud of her husband's ability to scratch out a profit in this earthen endeavor.

Pleasantries are exchanged. Paper work is signed. And, we wait for checks to be distributed.

And, then it happens.

The attorney walks in the room and hands the check to the seller. "What's this?" he puzzles after studying the check for a few seconds. "Where's the rest of it?"

"What do you mean?" answers the curt attorney.

"There should be more than this!" the man responds with increased anxiety in his voice. His wife perks up as she's bouncing the newborn in her lap.

I'm nervous. The mortgage guy's nervous. The attorney is nervous. Tension is in the air.

His wife looks at the check, and realizing their dreams are shot, starts crying.

The attorney, realizing that this guy isn't the sharpest knife in the drawer because he signed the contracts and all the paperwork indicating what profit he would receive, says, "Well, Sir, you had a second mortgage on both properties that had to be repaid. This is all there is."

More crying at the closing table. I try to explain that I didn't know what profit he would make, nor was it any of my business. But the damage is done. It's too late. The property has been funded, appraisals have been completed, the attorney's have earned their money, the mortgage guy did his job. So, I had nothing to do but leave shaking my head, and wondering how something like this could happen.

As these two owners found out, being a real estate investor takes more than just owning real estate. If you want to be successful and not wind up crying at a closing table some day, you have to know what you're doing. You have to do your homework. It all starts with education. Read every book you can find. Listen to the gurus. Go to investors meetings. Read the newspaper. Research online.

CHAPTER NINTEEN - MY MAILBOX MONEY STORY

My efforts to obtain "rich" status in life probably stem from the fact that I've never really wanted to work very hard. I always liked the saying, "Work smarter, not harder." Growing up, it was clear to me that this wasn't the path that was expected of me. It seemed like "working harder " was the key in life. But, I have grown to understand that most people "work hard" in some way or the other. The path I've chosen is not physical work but working my mind. The difference though, is that my work seems more like fun. When you make a few phone calls, visit a property to check on a contractor's work, and go to the mailbox to collect money, that really doesn't seem much like work.

Using leverage has been the key. Just like you can move something extremely heavy with a fulcrum, you can create great wealth using the leverage of other people's money and other people's labor. I use the bank's money to finance my properties. Bank money is extremely cheap and using their money is much better than using your own money. The leverage part comes in leveraging, for instance, a $10,000 down payment to purchase a $100,000 property. This leverage, or financing, creates some positive cash flow and provides an appreciating asset. Even if the property appreciates only the amount of normal inflation, which is 3%, then the value in one year would be $103,000. Based on your $10,000 investment, your rate of return has increased to 30%. That's a great number and that doesn't even include your cash flow, tax savings, or your principal reduction.

Leveraging other people's labor comes from your tenants' paying the rent. They go out every day and work to pay the bills. Their work is leveraged to pay the rent. In essence, you have employees working for you without the headaches, payroll, benefit issues, etc. that you would have with real employees… all the benefits of having an employee with none of the headaches.

I've done a lot of deals over the years. As I mentioned in a previous chapter, my first deal was keeping the house that I lived in. My family and I just kept the house, rented it out, and moved to another house. This one deal netted us about $300 per month.

MAILBOX MONTHLY MONEY $300

Deal two was a duplex on a street of ten other duplexes. It was listed for sale by a local real estate guy, and it appeared to be underpriced to me. Prior to even making an offer on the property, I snooped around and talked to the tenants. Much to my surprise, they told me that the rent was cheaper than any other building in the neighborhood. They also told me about the owner's situation and I began to understand that I had found a tired landlord. It was a really good building, well made, strong tenant history, but the guy was just tired of dealing with tenants. It never hurts to walk around and ask questions. Most people will tell you anything if you just ask. So, I made an offer to the owner and we struck a deal. Then I started my due diligence. After having a survey completed, I discovered a small problem. The exterior deck was actually over building line setback by just a few feet. I called the local planning office and discovered it wasn't that big of a deal to them. However, even though I wasn't worried about it, I knew this could be a potential problem to deal with in the future. I then called the seller's broker and told him of the problem and suggested a price reduction to compensate for the issue. The owner reluctantly agreed to it, and we closed on the deal. I put 10% down on the property, less a 5% brokerage fee, for a total of about $5,000 out of my pocket. The property rented for $650 per unit (after I adjusted it to market rents) and the mortgage was $750 per month. This left me a positive cash flow of $550 per month for the entire building.

MAILBOX MONTHLY MONEY $850

My third deal was a house in bankruptcy. A real estate friend of mine called me to tell me of a house she had for sale that I had to take a look at. The property had some minor termite issues that had scarred away any buyers. But, the house would easily be valued at $150,000 and I could buy it for around $95,000. I knew that in the worst case scenario this termite problem would take around $5,000 to repair. I made an offer on the building, went to the federal bankruptcy hearing, and came to an agreement on the house. My maintenance guy completed the termite repairs for about $4,500, and I rented the property to a family. The property generated about $275 per month after mortgage debt.

MAILBOX MONTHLY MONEY $1,125

My next property was a four unit purchase on a street of about 20 units. These units were on the corner, in pretty good shape and in the downtown area of a local community. I tracked down the owner, who was an absentee landlord. He agreed to sell the properties for probably 75% of their value… why I don't know to this day. But, at the time, I didn't question it much. I closed on the property and created another $1,500 in monthly cash flow. Now, we're getting somewhere – I've reached about half of my income from the government job, and I'm starting to realize that this could eventually replace my 9 to 5.

MAILBOX MONTHLY MONEY $2,625

Another foray into single family houses created additional income. This was a group of four houses that belonged to an investor friend of mine. All four properties were in good neighborhoods, were in top shape, and had tenants paying good rents. This deal netted another $1,200 per month.

MAILBOX MONTHLY MONEY $3,825

My next deal was two duplexes on the same street of my original duplex. Each duplex was owned by a different owner that I had contacted separately. I was on a roll and had some strong interest in buying the whole street. I put the properties under contract and scheduled the closings for the same day. One of the owners decided about a week before closing that he just really didn't want to sell the property.

I couldn't let this happen, since I had put a lot of money into the purchase by this time and was well on my way to financial freedom. The closing attorney was kind enough to call him and put the fear of lawsuits into him to get him to closing. He reluctantly showed up, but I could tell that he really wanted to renig on the agreement. Cash flow created was an additional $1,650 after mortgage debt.

MAILBOX MONTHLY MONEY $5,475

I had finally reached my goal: $5,475 per month, or $65,700 per year This was enough money to pay my personal expenses and allow me to quit my day job. Of course, I haven't stopped there. I've continued to add properties to my collection. My wife says that I "like to play real life Monopoly." I guess I agree with that. Owning real estate has been fun and entertaining, just like that famous board game.

CHAPTER TWENTY – CONCLUSION

As I had started my mailbox money program, I wondered where I would be in five or six years. It started out small, just $300 per month on my first deal. But, I kept adding two or three properties per year, until I reached my cash flow equilibrium… the point where I could quit my day job, where my rental property cash flow equaled my personal living expenses. After only about six years of real estate investing, I reached the point where my income from my rental properties was paying my personal expenses. At the young age of 37, I had effectively retired from the day-to-day grind of a job. I handed in my resignation to my boss with such a relief. Mostly a relief that I had finished what I had dreamed of… to use my mind to create freedom for myself and my family. It's a great feeling to go to bed on Sunday night, knowing I don't have to head to the office on Monday morning.

Whenever you dream big, there will be naysayers. There are people out there who don't want you to succeed. They don't know it, but your success makes them feel like failures. It's sort of like the guy in prison who really doesn't want his buddy to get out. Knowing his cell mate's leaving highlights his staying.

I can tell you as I prepared to leave my government job and approached mailbox money freedom day, many "friends" thought I was crazy. Their responses were veiled concerns. What will you do about benefits? I'll buy them. What about retirement? I'm retiring right now. What about job security?

You will have doubts and your friends will feed off of these. As I was, you will have to be strong-willed and go after what you want. If you ever want to break away from your daily job, then you have to make hard choices like I did. Live in smaller houses than your friends, don't drive brand new cars every two years – make some sacrifices. Mailbox money is not for everybody. It can be challenging. There will be some work, but it's not a daily grind. It will be the most rewarding financial experience you can imagine. If you can dream it, you can achieve it.

One of my favorite quotes has been on our refrigerator for about ten years. It's there for my wife and kids to see and to remind us every day. It's from Orison Swett Marden, an American writer from the early 1900's and founder of *Success Magazine*.

It reads: "All men who have achieved great things have been great dreamers."

Be a Great Dreamer.

MAILBOX MOO-LA.COM

...HOW REAL ESTATE CASH COWS PUT MONEY IN YOUR MAILBOX...

SUPPLEMENTAL WORKBOOK AND ANSWER KEY

Application of math principles to the concept of owning real estate can provide an investor with a better understanding of how to make money in the real estate market.

Real estate investing can be a rewarding experience. It provides the investor a way to leverage financed funds to increase his or her return on investment; and at the same time, providing a living or working environment for someone's enjoyment.

Investing is giving up something today for something tomorrow. Your job as an investor is to carefully consider all the hurdles to determine how best to use your limited funds to create more funds for the future.

Real estate is the number one generator of wealth in the United States. Most of the first generation millionaires in America received the majority of their wealth through real estate investments. It is with this in mind, that we created this workbook supplement to the mailbox moo'-la book which further enforces real estate principles and math principles simultaneously.

Being a real estate entrepreneur can take many forms, from renting out a house, to owning apartments or retail shopping centers, or developing raw land. With a fundamental understanding of these principles and the math required behind these principles, you will have a solid foundation for understanding the world's greatest wealth generator; and at the same time, honing valuable math

HOW MUCH IS THE RENT?

Determining the value of most real estate starts with calculating the amount of income that can be collected. This can be in the form of rent, late fees, or other income generated by the property. Therefore, it is important to know how to calculate what is called the "gross income." The term "gross income" is defined as, "the total amount of income collected over a period of time prior to subtraction of expenses." The "gross income" will help us in later chapters to determine the value of a real estate investment.

Problem

1. An investor owns a two unit building (called a duplex). Each tenant pays $800 per month in gross rent. What is the yearly gross rent for the entire building?

2. Johns owns a 10 unit apartment complex. Each unit produces $11,000 per year in gross income. What is John's yearly gross income?

3. Emily owns a building with a dog groomer as a tenant. The tenant pays $1,500 per month. What is Emily's yearly gross income?

4. Tammy has purchased a four unit apartment. The units together produce $4,400 per month in gross rents. What is Tammy's yearly gross income?

5. Brian owns twenty five single family houses. The gross yearly rent is $285,000. What is the average gross monthly rent for each home?

6. An investor owns a 20 unit apartment building. One half of the units are one bedroom apartments and the other half are two bedroom apartments. The one bedroom rent is $600 per month. The two bedroom rent is $725 per month. What is the yearly gross rent for the apartment building?

7. John owns three houses and collects rent every two weeks, not every month. The rent is $300 every two weeks. What is his gross yearly rent on the three houses?

8. Penn owns a shopping center with three stores: a Nail Salon, a Sandwich Shop, and a Barber Shop. Each business pays $2,000 per month in gross rent. What is the gross yearly rent for the shopping center?

9. Penn also owns a small apartment complex. There are 30 units and the gross monthly income equals $30,000. He also owns a Laundromat on the property that generates another $25,000 per year in gross income. What is the gross yearly income from the property?

10. Brian wants to purchase a small office building that is rented to Chandler Chiropractic & Associates. Dr. Chandler pays $3,000 per month. However, Brian has found another tenant, Dickenson Attorneys at Law, that will pay $1,500 every two weeks. Which tenant would generate the most gross yearly income for Brian?

IS IT A GOOD DEAL?

Most rents for commercial buildings, or apartments, are determined based on a cost per square foot basis. In other words, the rent is determined by taking an amount per square foot and multiplying it by the square foot of space someone leases. Since tenant spaces are all different sizes, this method is an easy way for potential tenants to compare the different spaces. It's a way for the tenant to figure out if they are getting a good deal. While different areas of the country and different landlords use different calculations, we will use a standard per year rent calculation. For instance, a property that rents for $1 per month per square foot, would also rent for $12 per year per square foot. Unless otherwise noted, our rents will be stated in the form of the per year rent.

As an example, a retail strip center charges $20 per square foot per year in rent. A 1,000 square foot space then would rent for $20,000 per year. $20 x 1,000 square feet = $20,000

PROBLEMS

1. A hair salon pays $15 per square foot for 2,000 square feet of space. What is their yearly gross rent?

2. A barber shop pays $40,000 a year in rent. If their rent is $20 per square foot, how many square feet of space are they renting?

3. Jorge owns a building in downtown and rents the building to a delicatessen. The store is 4,000 square feet in size and the tenant pays $25 per square foot. What is Jorge's yearly gross rent?

4. A local pharmacy pays $50,000 a year in rent. If there space is 2,000 square feet, what is the per square feet costs of the space?

5. A bakery is looking for new space. If the most they want to spend is $30,000 per year and they need 1,500 square feet, what is the most they can pay per square foot for the space?

6. A new grocery store is looking for a new location. They have found two spaces that they like. Space A is 50,000 square feet and rents for $15 per square foot. The other, Space B, is a 45,000 square foot space and rents for $18 per square foot. Which space will be cheaper rent for the grocery store?

7. Brian owns a retail shopping center with four tenants. Two tenants rent 2,000 square foot each, and two tenants have 5,000 square foot each. If Brian requires $20 per square foot for each tenant, what is the gross monthly rent for the entire building?

8. A bank just foreclosed on an office building that has a tenant that is paying $36,000 per year in gross rent. The building is 5,000 square feet. How much per square foot is the tenant paying in gross rents?

9. The bank, from problem #5, has offered to let the tenant out of the lease. The tenant has found space in a similar building, Building B. The rent is $10 per square foot and the building is 4,000 square feet. Which gross yearly rent is cheaper for the tenant?

10. Tammy owns an apartment complex. Her average rents are 95 cents per square foot per month. If the average apartment is 1,000 square feet. What is the gross yearly rents for 20 of these units?

WHERE DID MY TENANTS GO?

As a landlord, once you collect the gross rents, you must deduct your expenses from this rent. These expenses are known as operating expenses. Expenses can be property taxes, property insurance, maintenance and repairs, or vacancy. The bane to any landlord's existence is vacancies. Nothing will cost you more money, more headaches, and more sleepless nights than having vacancies. But, you'd better "cowboy up," as they say out West. Because, if you own a rental property, then you will have vacancies. We refer to this inevitable situation as the "vacancy rate." The "vacancy rate" is a percentage of time that you will have vacancies over a year period. It can range anywhere from five percent to twenty percent. Vacancy rate is similar to the unemployment rate…it's the amount of time that your units will be unemployed. Typically, as with the unemployment rate, five percent is about the best you can expect from the vacancy rate.

Now, I used to think when I owned just one unit, that this vacancy rate made little sense. My logic was that either it's vacant or not…so the vacancy was either zero percent or one hundred percent.

But, as I began to gain more experience as an investor, I learned that over a lengthy period of time; say five years, that the vacancy rate for my units tended to settle right in at five percent per year.

A large part of this is due to tenants moving out and how long it takes to get a unit ready to rent again. Even if you had a great tenant that left your unit in perfect shape, there's still a turnaround time. A simple five percent vacancy means that out of the 52 weeks of the year, that it would be vacant roughly two and a half weeks out of the year. This doesn't leave a lot of time to clean the unit, advertise, show it to a few people, sign a lease, and work around the tenant's move-in date.

When you are calculating income, you should always use this vacancy rate in your calculations.

As an example, if your gross income is $10,000 per year, and there is a 5% vacancy rate, then you should expect to be out of pocket at least $500 in vacancy over the year period. $10,000 x .05 = $500

PROBLEMS

1. Joshua has two houses that he rents for $1,000 per month each. He knows that he must apply a 5% vacancy rate to his gross rent. What is the dollar amount of this vacancy per year?

2. Barbara is a new investor and has one house that she rents to a young couple for $950 per month. She doesn't apply a vacancy rate to the income, because it's never been vacant since she bought it six months ago. Should she apply a vacancy rate anyway? Why or why not?

3. Francisco's apartments generate $35,000 per year in gross rents. Francisco has learned that a 5% vacancy rate should be applied to his gross rents. What is the dollar amount of this vacancy rate calculation?

4. Emily has purchased an office building to rent to an accountant. Her tenant, the accountant, pays $40,000 per year in gross rents. If the vacancy rate is 10% in this area, what is her net income after deducting the amount of the vacancy?

5. John's gross income is $20,000 on an office building he owns. The vacancy rate for this area is generally around 5%. What is the vacancy costs in dollars for John? If John's building becomes vacant, does that change the vacancy rate for John? Why or why not?

6. No matter how hard she tries, Bekah cannot keep her apartments rented all the time. She has 10 apartments that rent for $800 each per month. She knows that she should apply a vacancy rate because of this problem. If she applies a 5% vacancy rate, what is the dollar amount of this vacancy?

7. Pendleton owns a building with two restaurants in it. A sandwich shop pays $30 per year per square foot in rent and has approximately 1,000 square feet. The pizza parlor pays $25 per year per square foot in rent and has approximately 1,500 square feet. Pendleton knows that, since restaurants are difficult businesses to operate, they have pretty high vacancy rates. He decides to use a 12% vacancy rate. What is the dollar amount of this vacancy calculation?

8. In the example above, what is Pendleton's income after subtracting his vacancy expense from the gross rents?

9. Emily has an interior design studio in a renovated downtown building. She rents space from a local business man for $18,000 per year. If he applies a 7% vacancy rate, what is the income after subtracting this vacancy rate?

10. Josh owns a computer programming business and rents space for $30,000 per year. His landlord applies a 10% vacancy rate to this building. What is the dollar cost of this vacancy rate?

IS THERE ANY MONEY LEFT?

Other than vacancy, there are other costs that are also called "operating expenses". The most common of these are property taxes, property insurance, and maintenance costs. To eventually determine the value of a real estate property, which we will do in a later chapter, we must calculate the income after subtracting these expenses. These operating expenses include the items below:

1. Real estate and personal property taxes
2. Property insurance
3. Management expenses
4. Repairs and maintenance
5. Utilities
6. Accounting and legal services
7. Vacancy

To eventually determine the value of a property, we will calculate the net operating income (NOI). The (NOI) net operating income is a very common term used by real estate investors. It refers to the yearly income you have on the property after subtracting your expenses. One important expense that we do not include in calculating the NOI is the mortgage payment. The reason is the value will not be affected by the amount of the mortgage payment, since one person may pay cash and one person may put down only ten percent. The value is strictly based on the income minus the expenses.

To determine this net operating income, we simply take the gross income and subtract the operating expenses, including the vacancy expense. An equation that can be used for this calculation is:

Gross rents (GR) minus the operating expenses (OE) equals the net operating income (NOI).

GR – OE = NOI

PROBLEMS

1. An investor collects $18,000 per year in gross rents. His operating expenses equal $3,000 per year. What is his net operating income?

2. John's investments create $5,000 per month in gross rents. If his yearly operating expenses equal $5,500, then what is his monthly net operating income?

3. Bekah owns a dog grooming business. She rents a small building for $12,000 per year. The owner of the building has operating expenses of $1,675 per year. What is the owner's net operating income?

4. Bob owns a building and rents it to a car wash. The car wash pays $50,000 a year in gross rent. Bob's operating expenses are $5,000 per year and his mortgage debt costs him $10,000 per year. What is Bob's net operating income?

5. Royce owns a house that he converted into an office. A potential tenant has offered him $995 per month in gross rent. The tenant agrees to pay the property taxes of $1,500 per year. The other expenses are Royce's responsibility. Royce's expenses total an additional $1,700 per year including the vacancy rate. What is Royce's net operating income?

6. Brian owns 18 apartment units that generate $216,000 gross rents per year. His property taxes are $45,000 per year, his insurance expenses are $9,000 per year, his maintenance costs is another $5,000 per year, and the vacancy rate of 5% costs him an additional $10,800 per year in costs. What is Brian's net operating income?

7. Doug owns a retail center with four spaces of 2,000 square feet each. They generate $20 per year per square foot in gross rents. His operating expenses, including vacancy, are $5 per square foot per year. What is his net operating income?

8. Barry recently purchased a building with an assisted living facility as a tenant. The property taxes are $2,000 per year, the property insurance is $1,700 per year, and the maintenance costs another $4,000 per year. The tenant pays $60,000 a year in rent. Using a vacancy rate of 10%, what is Barry's net operating income (NOI)?

9. Amanda bought a house to rent in a small town in Mississippi. The monthly rent is $600 per month. Her expenses equal $1,800 per year, not including vacancy rate. Vacancy rate for this area averages 8%. What is Amanda's net operating income?

10. Paul recently rented a small 1,500 square foot location for a barbeque restaurant. His landlord agreed to accept $10 per square foot per year as the rent. The landlord's total expenses, including vacancy, are $250 per month. What is the landlord's net operating income?

WHAT IS IT WORTH?

Next we will take the NOI (net operating income) and determine the value of a real estate investment using the "capitalization rate." The cap rate, for short, is a rule of thumb that we use to compare investments. A simplified definition for cap rate is: it is the return on your investment if you paid cash for the property. Cap rate is expressed as a percentage. Virtually all real estate values are determined by this method.

The formula to determine the value using the cap rate is:

value = NOI / cap rate.

To determine the cap rate, the formula is:

Cap rate = Value / NOI

And to determine the NOI, the formula is:

NOI = Value x cap rate

Let's look at an example. If you paid $100,000 in cash for a real estate property and rented it for $10,000 in income per year; then you would have a 10 percent return on your investment. This return on your investment is also called the cap rate.

Value = $100,000

NOI = $10,000

Cap rate = value / NOI

= $100,000 / $10,000 = 10

Cap rate = 10%

The actual cap rate that you use is entirely up to you as an investor. It is just a rule of thumb that you will learn from experience. Cap rates can range from 4% to 20%, depending upon the investor's beliefs about the market and the property they want to buy. In some ways, this method of determining the value is very subjective. However, as you begin to invest in real estate, you will start to form your own opinions about what cap rate you would like to receive from your investment.

Note: As with our other calculations so far, we do not consider the amount of mortgage payments. This mortgage debt is not important to the value of the property.

PROBLEMS

1. Dr. Lee has purchased a retail building with a NOI (net operating income) of $50,000. He knows from experience that a fair cap rate would be 10% for retail buildings in this area of the country. Based on that assumption, what is Dr. Lee's value of the real estate?

2. Judy owns an apartment complex with 20 units. The NOI (net operating income) is $150,000. Using a cap rate of 12%, what is the estimate of value?

3. Vicky owns 10 single family houses with $120,000 per year in NOI (net operating income). If she sells these houses to another investor based solely on the cap rate formula. What would her value be based on a 13% cap rate?

4. Brian owns a shopping center with a grocery store and three other tenants. He believes his building is worth $5,200,000 based on a cap rate of 8%. What is his NOI (net operating income)?

5. John's real estate investments create a NOI (net operating income) of $150,500 per year. His mortgage debt is $30,000 per year. If he believes his investments are worth $1,505,000, what cap rate is he using to determine this value?

6. One of Tom's properties has a NOI (net operating income) of $50,575 per year. He knows that cap rates for this type of property range from 8% to 9%. What would be the value of the property based on both of these cap rates?

7. Based on the answer above, if Tom wants to sell the property, which cap rate would he prefer?

8. If John wants to buy the property from Tom in the question above, which cap rate would he prefer? Why?

9. Obviously, there is a correlation between the value and the cap rate. If the value goes up, what happens to the cap rate? If the value goes down, what happens to the cap rate?

10. Joe, the Mayor of a small town in Georgia, owns a downtown building. He has calculated that the value of the building is $590,000, based on a 10% cap rate. What would the value be if he used a 9% cap rate instead?

HOW MUCH WILL I MAKE?

Now we have determined something very important: the value of a property. Next, we will look at how much money we will actually make, called the "cash flow". When you go to a bank to borrow money to purchase something this is called financing. Using a credit card to purchase clothing, food, or a computer is using financing. While it's possible to purchase real estate without financing, most real estate investors will use some form of financing.

Financing is the use of borrowed funds for a purchase. Financing is also called leverage, because you are using borrowed funds to "leverage" a purchase. Using leverage increases your power by using other people's money, namely your banker's money.

One advantage of using this leverage is obviously you can purchase more expensive property. Without financing, most of us wouldn't be real estate investors. Let's face it, most people can't whip out $200,000 to buy a rental house, but some of us can find $10,000 or $20,000.

It also allows you to keep your cash to purchase even more properties. This helps reduce your risk since it allows you to diversify your real estate investments. If you have one or two units in numerous subdivisions or in different cities, your risk is spread out. If a subdivision goes down in value, the rest of your properties pick up the slack. If a particular area decreases in value because of an unsightly landfill or deterioration of a school district, then you're protected by the rest of your real estate investments.

But, my favorite reason for using leverage is that it increases your return on investment. Let's look at an easy example.

Let's say your long lost uncle passes away and gives you $100,000. What do you do with it? Maybe buy some real estate?

Let's say a $100,000 house rents for $1,000 per month. If you pay cash for the house, then your cash flow is roughly $12,000 per year, or a 12% return on investment. Not bad.

But, if you use financing, then you put $10,000 down and have a $90,000 mortgage. With a 7% interest rate, your payment would be around $600 per month. You would make $400 per month ($1,000 in rent minus $600 mortgage payment) You would make $4,800 per year. Remember, your initial down payment was only $10,000, yielding a whopping 48% return! That's four times the rate of return from paying cash, as in the example above. Now, that's a huge return and that's why I get excited about investing in real estate and using my banker's money .

To take this example further: Since you still have $90,000, let's say you buy 9 more houses. So, now you have a total of ten houses, each producing and income of $4,800 per year. That's a total of $48,000 per year on a $100,000 investment. Still a 48% return and a lot of money in your pocket. That's why I love leverage!

There are generally two types of loans: fixed loans and variable loans. Fixed rate loans will not vary over time. Their interest rates are "fixed"; hence the name. The payment on a fixed rate loan will be the same in the future as it is now. Variable rates will vary, or change, over the years. Their rates generally start out low; as a teaser, then go up as the loan gets older.

Typically, if you buy a house or duplex, you get a 30 year loan, which means if you pay the same monthly payment every month for 30 years then the loan is paid off. Some properties, such as commercial buildings and apartments, may use a shorter time period, such as 20 years.

When someone talks about paying the mortgage payment, they are usually talking about the common four aspects of a loan:

Principal

Interest

Property taxes

Property insurance

Principal is the amount of money you have borrowed. Interest is the amount of money the bank makes because you've borrowed money from them. Most loans contain both principal and interest. However, sometimes a bank will allow you to do an "interest-only" loan. That means, that you don't pay any of the principal amount; you just pay an interest payment every month.

When you finance a real estate investment, sometimes the bank will require you to "escrow" the property taxes and property insurance. These are two very important items that the bank wants to make sure are paid. So, they will take the yearly amount of these two items divide them by 12 and require you to pay this amount every month. However, if you remember, we accounted for these two items in a previous chapter. They are accounted for in the expenses section where we determined NOI (net operating income). Therefore, when we talk about mortgage payments in this chapter, we do not include taxes and insurance, as they have already been subtracted.

CASH FLOW

If we use financing in buying real estate, then we can take our NOI (net operating income) and subtract the yearly mortgage payment. Remember, NOI (net operating income) is a yearly number. But, most people think of the mortgage payment as a monthly expense. So, you may have to multiply your monthly mortgage payment by 12 months to calculate the yearly mortgage payment.

So, Cash Cow lovers, here is the number we've been waiting for. This is our "cash flow." This is the amount of money we get to put in our pockets.

Here's the formula:

NOI – yearly mortgage payment = yearly cash flow

PROBLEMS

1. Tommy rents a building to a television repair shop. Tommy's NOI (net operating income) is $11,000 per year. His yearly mortgage payments total $8,000. What is his yearly cash flow?

2. Audrey Ann wants to purchase a building. Her tenant, a beauty salon, will be paying rent. Audrey Ann's NOI (net operating income) will be $15,500 per year. Her mortgage payment will be $11,655 per year. What is Audrey Ann's yearly cash flow?

3. Brian owns a duplex apartment building. His NOI from the building is $24,000 per year. His monthly mortgage payment is $800 per month. What is Brian's yearly cash flow?

4. Paul is losing money on his investment. His NOI (net operating income) totals $12,000 per year on a small, two bedroom house he owns in the city. If his mortgage payment totals $900 per month, what is his cash flow? Is he losing money?

5. Paul must be pessimistic, because he also thinks he's losing money on a three bedroom house he owns in the suburbs. His NOI (net operating income) is $15,000 per year. His mortgage payment is $1,400 per month. What is Paul's cash flow? Is he losing money?

6. John's mortgage payment is $1,200 per month. $200 of that goes to property taxes and insurance. His real estate investment produces $15,000 a year in NOI (net operating income). What is John's cash flow?

7. Jeremiah owns a building with a car wash as a tenant. His monthly mortgage payment consists of $500 in principal payments, $200 in interest payments, $300 in property taxes, and $75 in property insurance. The car wash produces $22,555 a year in NOI (net operating income). What is Jeremiah's cash flow?

8. Sally wants to purchase a house to rent out. Her initial calculations indicate a NOI (net operating income) on House A to be $10,555 per year. House B will generate a NOI of $11,675 per year. Assuming her mortgage payment on either property will be $750 per month, what is the cash flow on House A and what is the cash flow for House B? Which is the better investment?

9. Francisco has determined that an investment in a 25 unit apartment complex will provide a NOI of $275,000 per year. If his principal payment is $60,000 per year, his interest payment is $173,000 per year, and his taxes are $5,000 per month, what is his yearly cash flow?

10. Ralph's banker insists that his mortgage payment include property taxes and property insurance. Ralph's principal and interest is $895 per month. His property taxes and property insurance totals $300 per month. If Ralph's NOI is $30,600, then what is his yearly cash flow?

WHAT DO I DO NOW THAT I'VE MADE ALL THIS MONEY?

Now, that you've made money on your real estate investment, you will have to pay some taxes. However, real estate is one of the best, if not THE best, tax shelters available. The term "tax shelter" has some negative connotations, because of frequent misuse. But, the great part of real estate tax law is that it allows you to not pay taxes on some of your income. In other words, you get to "shelter" some of this income from taxes.

Real estate is a legal tax shelter that you can use to reduce your personal income taxes. The government agency that is in charge of deciding how much in taxes we pay is called the IRS (Internal Revenue Service). The primary tax shelter for real estate used to be called depreciation by the IRS, but is now referred to as "cost recovery". I'll use depreciation since it's an easier term to use. Depreciation means that because buildings get older and require more and more maintenance over the years, then their value declines because it takes more money to keep them repaired properly. The value of the land is not depreciated since land cannot depreciate. It remains virtually the same over time.

The beauty of the tax law is that while your real estate investment is actually appreciating, the federal government allows you to pretend that it's depreciating in value. Residential property is depreciated over 27 ½ years. In other words, the IRS allows you to pretend that the buildings on the property will be worth nothing in 27 ½ years. So, every year you'll get to depreciate the value the same amount until 27 ½ years later. Commercial is depreciated the same way except over 39 years.

For an easy example, let's look at a rental house that's worth $100,000. Since land doesn't depreciate, we only consider the value of the house on the property. So, in this example, the actual house may be worth only $80,000 and the land that is sits on may be worth $20,000. So, you simply divide $80,000 by 27 1/2. This comes to an amount of $2,909 per year of depreciation value.

This is to say that the IRS assumes that the building depreciates the same amount every year for the next 27 ½ years, an amount of $2,909. This amount comes off of your personal taxes, but only for investment properties. You are not allowed to deduct deprecation in your principal residence...the one you live in.

So how does it save you money? The amount that this saves you in tax money depends upon your income tax bracket. If you are in the 36% tax bracket, then in this example, your personal taxes would be reduced by $1,047 per year. ($2,909 x 36%).

PROBLEM

1. A house that is valued at $80,000 is allowed depreciation of $2,909 per year. How many years will the investor be able to use this depreciation amount?

2. In the example above, if your personal income tax percentage is 21%, then how much will you save in taxes per year?

3. Wynona has a commercial building that is valued at $350,000 and the land is worth $75,000. Using a depreciation amount of 39 years, what is the yearly depreciation amount?

4. If a house and a commercial building are valued at the same amount, then which one will produce the most yearly amount in depreciation?

5. Benjamin has four houses that he rents out that he has owned for 11 years. Each building is valued at $120,000. The land is worth $35,000 per each lot. How many years should Benjamin use to determine the depreciation?

6. If Benjamin in question #5 depreciates the buildings, what is the yearly amount of depreciation value?

7. If Benjamin in question #5 is in the 46% tax bracket, then how much will this depreciation save him in personal taxes?

8. In question #7, how many years will Benjamin be able to save this amount of money on his personal taxes?

9. If Donald owns a commercial building that is valued at $480,000, not including the land value, then what is the amount of deprecation per year?

10. From Question #9, what is Donald's personal tax savings, if he is in the 36% tax bracket?

CAN I SAVE EVEN MORE ON TAXES?

There are several more deductions that you can take when using real estate as an investment. One of those items is the payment of interest. As we discussed in a previous chapter, mortgages are usually made up of two main parts: principal and interest. The interest part of this payment is deductible on your personal taxes. This can result in additional tax savings.

For instance, if you have a loan of $100,000 at 7% interest, then the monthly payment is $665.30. The yearly principal amount will be $1,015.81 and the yearly interest payments total $6,967.82. (we calculate this on a financial calculator)

This yearly interest payment will be deductible from your personal taxes. If you are in the 25% federal tax bracket, then your personal taxes will be reduced by $1,741.95 per year ($6,967.82 x .25). Add this to your depreciation deduction that we discussed in the previous chapter, and you are well on your way to reducing your taxes quite a bit.

PROBLEM

1. If John pays $5,125 per year in interest on his investment and is in the 25% federal tax bracket, what is his personal tax savings?

2. Tammy owns two houses. She pays $6,324 per year in interest on one house and $5978 per year in interest on another house. Both houses are investment properties. What is her total in interest that she pays yearly?

3. John owns a commercial building with three tenants. The interest on the building is $25,435 per year. If John is in the 35% federal tax bracket, what will be his tax savings generated by this interest?

4. If Tim saves $3,500 per year in taxes just based on his interest deduction, how much interest does he pay if he is in the 25% tax bracket?

5. How much in taxes would Tim save if he were in the 36% tax bracket?

6. If John pays $8,967 per year in interest, how much in taxes will he save if he is in the 25% tax bracket?

7. Robert pays $2,539 in principal and $17,419 in interest per year on a four unit apartment that he owns. Can he deduct the principal amount that he pays? Why or why not?

8. From #7 above, what is Robert's tax savings based on a 36% tax bracket?

9. What would Robert's tax savings be if he were in the 25% tax bracket?

10. If Samantha saves $3,905 per year in interest tax deductions and she is in the 25% tax bracket, then what is the amount of interest she pays?

HOW MUCH OF THIS CASH DO I GET TO KEEP AFTER TAXES?

In a previous chapter, we calculated "cash flow" created by our cash cows. In subsequent chapters, we learned of some of the tax benefits of real estate. Now, we will calculate our "taxable income." In other words, how much of this cash is subject to taxes. And, how much do I get to keep after paying taxes and after finding out my tax savings.

Let's remember how we got to this point from previous chapters:

Gross income

- Operating income

NOI (net operating income)

- Mortgage payments

Cash flow

- Tax deductions (deductions and interest)

Cash flow after taxes

Let's look at the following example. Rick purchased a building that leases for $30,000 per year. His expenses, (i.e. $3,000 property taxes, $1,500 vacancy expense (5%), $2,500 maintenance expenses, and $700 legal expenses) total $7,700.

Using our formula: Gross income – operating expenses = NOI

Rick's NOI (net operating income) equals: $30,000 - $7,700 = $22,300

Rick's mortgage payment: $19,160 per year.

Using our formula: NOI – mortgage payment = cash flow

Rick's cash flow is: $22,300 – 19,160 = $3,140

As we learned in a previous chapter, we can determine Rick's property value based on the NOI (net operating income). Remember, we use a cap rate to determine this. So, if we use a 9% cap rate, we will find his value using the following formula:

Value = NOI / cap rate

Value = $22,300 / .09 = $247,777

We can estimate the value of the building on the property by multiplying the value of Rick's property by 80%. Remember, the land cannot be depreciated, only the building. This 80% is just a rule of thumb we will use to help us with this calculation.

So, Rick's building is valued at: $247,777 x .80 = $198,222

Rick's building is a commercial building, so we are allowed to depreciate the value the same amount every year for the next 39 years. (27 ½ years if it were residential)

$198,222 / 39 years = $5,082.62 per year

Also, we can deduct the interest that Rick pays on his mortgage debt. We find from our financial calculator that the interest is $16,722.77 per year.

So, Rick is allowed to deduct $5,082.62 + $16,722.77 = $21,805.38

TAXABLE INCOME

Now, we can take what we learned in the previous two chapters on depreciation and interest deductions. The taxable income is determined by subtracting these two from the NOI as in the following:

NOI – depreciation – interest payments

Rick's taxable income =

$22,300 (NOI) - $5,082.62 (depreciation) - $16,722.77 (interest) = $494.61

Here's the GOOD PART:

Remember, Rick's cash flow was $3,140. But, he only has to pay taxes on $494.61. If he is in the 25% tax bracket, then he only has to pay $123 ($494.61 x .25) in taxes.

He made $3,140 and only paid $123 in taxes. This equals only 3.9% of his actual cash flow in taxes.

So, Rick's after tax cash flow is: $3,140 – $123 = $3,017

PROBLEMS

Answer the following problems based on Rick's scenario above:

1. What was Rick's Gross Income?

2. What was Rick's operating expenses?

3. What is the formula to determine Rick's NOI?

4. If Rick were in the 35% tax bracket, what would his tax bill be?

5. If Rick were in this 35% tax bracket, what would his after tax cash flow be?

"A BIRD IN THE HAND"

You've probably heard the old saying, "A bird in the hand is worth two in the bush." This saying also applies to real estate investing. To refer to this concept, we use the term "future value." You will either receive income today, tomorrow, or in the future. It's important to understand this concept because most of your real estate income will come in the future. Therefore, you must know what that income is worth today. In my real estate courses, I've taught that a dollar today is worth more than a dollar tomorrow. This is due to two reasons:

1. Number one is the affect of inflation on the value of a dollar. Inflation is defined by Wikopedia.com as "a rise in the general level of prices of goods and services in an economy over a period of time." Inflation decreases the value of your dollar every day. If it takes one dollar today to buy a loaf of bread and in five years it costs two dollars, then the value of your dollar has been cut in half. Therefore, **your dollar is worth more right now than it will ever be.**

2. The second reason is the idea of risk. There is some level of risk in any investment that you won't get paid in the future. If you have the dollar in your pocket, there is no risk. You already have it and don't have to worry about receiving it later.

So, because most of your cash flow will happen in the future, it's important to know what that money is worth right now. Using a financial calculator, you can determine the value of future dollars based on what's called a "discount rate." It's also referred to as a "costs of capital rate." This is merely the interest rate that you think you would make on the money in some other investment if you didn't put it in this one. For instance, let's say to buy a property you have to put $10,000 as a down payment. Obviously, you have lost some opportunity with that money. You could have put it in the bank, you could have bought some stock, or some other investment. Your opportunity costs, then, must be determined and put into this equation. This interest rate is entirely based upon your individual circumstances –it's entirely your opinion or your experience that determines what "discount rate" you will use.

We can do some simple calculations to help us understand "future value." While most of these calculations are normally completed on an advanced financial calculator, I think some simple calculations will help us understand the concept.

Let's suppose that you've invested in a piece of land. It's a small two acre tract of land in a growing area that you bought a few years ago. A developer wants to build a day care on the property. Since the developer has to get the property rezoned to allow a day care site, he knows that there is some risk that he may not get it rezoned. He also knows that it will take possibly a year to have it rezoned.

He offers you the following: He'll either buy your property now for $75,000 before the rezoning OR he will rezone it and then pay you $85,000 a year from now. Which one should you do?

The first thing you must determine is your "costs of capital." As I mentioned above, what kind of interest rate can you expect to get from your investments is your "costs of capital." For this example, let's say that you're pretty good at investing in the stock market and have decided to use this money from the sale of the property to the developer to invest in stocks. Your usual return in the stock market has been 10%.

So, if you accepted the $75,000 from the developer, then the value of this money in one year would be:

$75,000 x .10 = $7,500

$75,000 + $7,500 = $82,500

If you wait a year, then you would receive $85,000 from the sale. If you sell it now, then you would receive $75,000, but this amount would be worth $82,500 a year from now. So this calculation helps you better understand the developer's offer. You know the offers are both much closer in value than they originally appeared. Now, you have a tool to make a better decision.

PROBLEMS

1. In the example above, what would be the future value of $75,000 if you used a 15% costs of capital interest rate?

2. In the example above, what would be the future value of the $75,000 if you used a 5% costs of capital interest rate?

3. In the example above, in one year, if the future value of the $75,000 equals $85,000, which deal would you take? Why?

4. John has an offer from a developer to buy his land. The developer has offered him $250,000 OR $272,000 a year from now. Using a 10% costs of capital, what would the $250,000 be worth in one year?

5. In #4 above, if John uses a 15% costs of capital, what would the $250,000 be worth in one year.

The following two real life scenarios will use all the skills we have learned so far.

SCENARIO #1

Ralph has leased a building for his new bank. The building is 4,000 square feet in size and the yearly rent rate is $16 per square foot. The owner of the building, Brian, expects $5,000 a year in operating expenses. Brian's mortgage debt on the building is $44,472 (This includes principal of $8,023 and interest of $36,449). Brian uses a 9% capitalization rate to determine value of his real estate investments and he is in the 35% federal tax bracket. The building is commercial and depreciation is based on 39 years.

1. What is Ralph's gross yearly rent?
2. What is Brian's NOI?
3. What is the value of the building?
4. Assuming the improvements on the land are 80% of the value of the entire property, what is the depreciation deduction amount?
5. What is Brian's cash flow before taxes?
6. What is Brian's taxable income?
7. What is Brian's cash flow after taxes?
8. What is Brian's cash flow if no taxes are owed?
9. Would Brian's yearly depreciation deduction be higher or lower if this building were considered residential?
10. If Ralph renegotiated the rent to $14 per square foot, what would Brian's cash flow before taxes be?

SCENARIO #2

Mr. Park Ko has purchased a multi-tenant building with three tenants. A Starbucks occupies 1,500 square feet, a hair salon is in 2,000 square feet, and a barbeque restaurant is occupying 2,600 square feet. The restaurant pays $25 per square foot, and the other two tenants pay $20 per square foot. Yearly operating expenses are $20,545. Cap rates for this type of investment are usually around 10%.

Mr. Ko has asked a commercial real estate broker to help him sell the property. However, he doesn't know how much to ask for it. He knows a similar building to his sold for $250 per square foot and believes that is a good comparable.

1. What is the yearly gross rent generated from all three tenants?
2. What is the NOI?
3. Given the parameters above, what is your estimate of value?
4. Do you consider the comparable sales price? Why or why not?
5. Using 80% to value the structures and a 39 year depreciation, what is Mr. Ko's yearly depreciation deduction?

ANSWER KEY

HOW MUCH IS THE RENT?

1. $19,200

   $800 per month x 2 units x 12 months = $19,200

2. $110,000

   10 units x $11,000 = $110,000

3. $18,000

   $1500 x 12 months = $18,000

4. $52,800

   $4,400 x 12 = $52,800

5. $11,400

   $285,000 ÷ 25 units = $11,400

6. $159,000

   There are 20 units. Divide the units in half (20 ÷ 2 = 10) and apply the $600 rent to 10 of the units, and apply the $725 rent to the other 10 units.

   $600 x 10 units = $6,000 per month

   $725 x 10 units=$7,000 per month

   $6,000 + $7,000 = $13,000 per month x 12 months = $159,000

7. $7,800

   $300 per month x 26 payments = $7,800

   (Paying every two weeks actually increases rents by two payments, instead of 12 monthly payments, there are 26 payments)

8. $72,000

   $2,000 monthly rent per tenant x 3 tenants = $6,000 per month total income

   $6,000 per month x 12 months = $72,000

9. $385,000

   $30,000 per month x 12 months = $360,000 per year income on the apartments

   $360,000 per year income + $25,000 per year income on the laundromat = $385,000

10. Dickenson Attorneys at Law will generate the most yearly income

    Dr. Chandler's rent $3000 per month x 12 = $36,000 per year

    Dickenson Attorneys rent $1,500 every two weeks x 26 payments (the number of two week payments in a year) = $39,000 per year

IS IT A GOOD DEAL?

1. $30,000

   $15 x 2,000 square feet = $30,000

2. 2,000

   $40,000 per year ÷ $20 = $2,000

3. $100,000

   4000 sf x $25 = $100,000

4. $25

   $50,000 ÷ 2,000 = $25

5. $20

   $30,000 ÷ 1,500 = $20

6. Space A will be the cheapest rent

   Space A 50,000 x $15 = $750,000 yearly rent

   Space B 45,000 x $18 = $810,000 yearly rent

7. $280,000

   Two tenants x 2,000 square feet = 4,000

   Two tenants x 5,000 square feet = 10,000

   4,000 + 10,000 = 14,000 square feet

   14,000 square feet x $20 per square foot = $280,000

8. $7.20

   $36,000 ÷ 5,000 square feet = $7.20

9. The rent is cheaper in the existing building.

   Existing rent is $36,000. Building B rent is $40,000 per year ($10 per square foot x 4,000 square feet)

10. $228,000

    95 cents per month (.95) x 12 = $11.40 per year

    $11.40 x 1,000 square feet per unit = $11,400 per unit

    $11,400 per unit x 20 units =$228,000

    Optional solution:

    .95 x 1,000 square feet per unit = $950 per unit per month

    $950 x 12 months x 20 units = $228,000

WHERE DID MY TENANTS GO?

1. $1,200

   2 houses x $1,000 = $2,000 per month

   $2,000 x 12 = $24,000 per year

   $24,000 x .05 = $1,200

2. She should apply a vacancy rate. Vacancy rates are average vacancies over an extended period of time. Six months is not long enough to determine the application of vacancy rates.

3. $1,750

   $35,000 x .05 = $1,750

4. $36,000

   $40,000 per year x 10% (.10) = $4,000 vacancy expense

   $40,000 - $4,000 = $36,000

5. $1,000 Johns' vacancy rate doesn't change if his building becomes vacant. Vacancy rate is a long term measurement of vacancy.

   $20,000 x .05 = $1,000

6. $4,800

   10 apartments x $800 per month = $8,000 per month

   $8,000 x 12 months = $96,000

   $96,000 x 5% (.05) = $4,800

7. $8,100

   Sandwich shop: $30 x 1,000 square feet = $30,000 gross rent

   Pizza parlor: $25 x 1,500 square feet = $37,500 gross rent

   $30,000 + $37,500 = $67,500 total gross rents

   $67,500 x .12 = $8,100

8. $59,400

   Total gross rents = $67,500 - $8,100 = $59,400

9. $16,740

   $18,000 x .07 = $1,260 vacancy expense

   $18,000 - $1,260 =$16,740

10. $3,000

    $30,000 x .10 = $3,000

IS THERE ANY MONEY LEFT?

1. $15,000

   $18,000 - $3,000 = $15,000

2. $541.67

   $5,000 x 12 = $60,000

   $60,000 – 5,500 = $54,500

   $54,500 ÷ 12 = $541.67

3. $10,325

   $12,000 - $1,675 = $10,325

4. $45,000

   $50,000 - $5,000 = $45,000

   (the mortgage debt has nothing to do with this answer)

5. $10,240

   $995 x 12 months = $11,940

   $11,940 - $1,700 = $10,240

   (the property taxes are paid by the tenant and therefore are not an expense of the landlord's)

6. $146,200

   $216,000 - $45,000 - $9,000 - $5,000 - $10,800 = $146,200

7. $120,000

   4 units x 2,000 = 8,000 square feet

   8,000 x $20 = $160,000 (gross rents)

   Operating expenses = 8,000 square feet x $5 = $40,000

   $160,000 - $40,000 = $120,000

8. $52,300

   $60,000 x .10 = $6,000 vacancy expense

   $60,000 - $2,000 - $1,700 - $4,000 = $52,300

9. $4,824

   $600 x 12 months = $7,200 yearly gross rent

   $7,200 x .08 = $576 vacancy expense

   $7,200 – $576 - $1,800 = $4,824

10. $12,000
    1,500 x $10 = $15,000 gross yearly rent
    $250 x 12 = $3,000 yearly expenses
    $15,000 - $3,000 = $12,000

WHAT IS IT WORTH?

1. $500,000

   $50,000 ÷ .10 = $500,000

2. $1,250,000

   $150,000 ÷ .12 = $1,250,000

3. $923,076.92

   $120,000 ÷ .13 = $923,076.92

4. $416,000

   $5,200,000 x .08 = $416,000

5. 10%

   $1,505,000 ÷ $150,500 = 10%

   (The mortgage debt is not considered in determining the value)

6. $632,187.50 to $561,944.44

   $50,575 ÷ .08 = $632,187.50

   $50,575 ÷ .09 = $561,944.44

7. The 8% cap rate would give him a higher value. The lower the cap rate, the higher the value.

8. John would prefer the 9% cap rate if he were the buyer. The higher the cap rate, the lower the value.

9. Cap rates and value are like a see-saw. If the cap rate goes up, then the value goes down.

10. $655,555.55
    $590,000 x .10 = $59,000 (NOI)
    $59,000 ÷ .09 = $655,555.55

HOW MUCH WILL I MAKE?

1. $3,000

   $11,000 - $8,000 = $3,000

2. $3,845

   $15,500 - $11,655 = $3,845

3. $14,400

   $800 x 12 = $9,600 (yearly mortgage debt)

   $24,000 (NOI) - $9,600 = $14,400

4. $1,200 (Paul is not losing money)

   $900 x 12 = $10,800 (yearly mortgage debt)

   $12,000 (NOI) - $10,800 = $1,200

5. -$1,800 (Paul is losing $1,800 per year)

   $1,400 x 12 = $16,800 (yearly mortgage debt)

   $15,000 - $16,800 = -$1,800

6. $3,000

   $1,200 - $200 = $1,000 (Property taxes and insurance have already been accounted for in the NOI, so we must subtract this from the mortgage debt)

   $1,000 x 12 months = $12,000 yearly mortgage debt

   $15,000 - $12,000 = $3,000

7. $14,150

   $500 + $200 = $700 per month mortgage debt (we do not use taxes or insurance since they have been accounted for in the NOI)

   $700 x 12 months = $8,400 yearly mortgage debt

   $22,550 - $8,400 = $14,150

8. House B is the better investment

   $750 x 12 months = $9,000 yearly mortgage debt

   House A: $10,555 - $9,000 = $1,555

   House B: $11,675 - $9,000 = $2,675

9. $42,000

   $60,000 + $173,000 = $233,000 yearly mortgage debt (we do not use taxes since they have been accounted for in the NOI)

   $275,000 (gross rents) - $233,000 = $42,000

10. $19,860

    (we do not use taxes and insurance since they have been accounted for in the NOI)

    $895 x 12 months = $10,740 yearly mortgage debt

    $30,600 - $7,140 = $19,860

WHAT DO I DO NOW THAT I'VE MADE ALL THIS MONEY?

1. 27.5 years (Residential property is depreciated the same amount for 27.5 years)

2. $610.89
   $2,909 x .21 = $610.89

3. $7,051.28

   $350,000 - $75,000 = $275,000

   $275,000 ÷ 39 = $7,051.28

4. A house would provide a higher yearly amount of depreciation.

5. 27.5

6. $3,090.91

   $120,000 - $35,000 = $85,000 (value of house, not including the land, since we don't depreciate land)

   $85,000 ÷ 27.5 = $3,090.91

7. $1,421.81

   $3,090.91 x .46 = $1,421.81

8. 27.5 years

9. $12,307.69

   $480,000 ÷ 39 = $12.307.69

10. $4,430.77

    $12,307.69 x .36 = $4,430.77

CAN I SAVE EVEN MORE MORE ON TAXES?

1. $1,281.25

   $5,125 x .25 = $1,281.25

2. $12,302

   $6,324 + $5,978 = $12,302

3. $8,902.25

   $25,435 X .35 = $8,902.25

4. $14,000

   $3,500 ÷ .25 = $14,000

5. $5,040

   $14,000 X .36 = $5,040

6. $2,241.75

   $8,967 x .25 = $2,241.75

7. The principal amount that is paid on an investment loan is not deductible, because it is not an actual expense. It is merely a reduction of the amount owed on the loan.

8. $6,270.84

   $17,419 x .36 = $6,270.84

9. $4,354.75

   $17,419 x .25 = $4,354.75

10. $15,620

    $3,905 ÷ .25 = $15,620

HOW MUCH OF THIS CASH DO I GET TO KEEP AFTER TAXES?

1. $30,000

2. $7,700

3. Gross income – operating expenses = Net operating income

4. $173

   $494.61 x .35 = $173

5. $2,967

   $3,140 - $173 (from answer #4) = $2,967

A BIRD IN THE HAND

1. $86,250

   $75,000 x .15 = $11,250

   $11,250 + $75,000 = $86,250

2. $78,750

   $75,000 x .05 = $3,750

   $3,750 + $75,000 = $78,750

3. A wise investor would choose to accept the payment up front because of the risk involved in waiting a year.

4. $275,000

   $250,000 x .10 = $25,000

   $25,000 + $250,000 = $275,000

5. $287,500

   $250,000 x .15 = $37,500

   $37,500 + $250,000 = $287,500

SCENARIO #1

1. $64,000

   4,000 x $16 = $64,000

2. $59,000

   $64,000 - $5,000 = $59,000

3. $655,555.55

   $59,000 ÷ .09 = $655,555.55

4. $13,447.69

   $655,555.55 x .80 = $524,444.44

   $524,444.44 ÷ 39 years = $13,447.69 per year

5. $14,528

   $59,000 (NOI from #2 above) - $44,472 (mortgage debt) = $14,528

6. - $35,398.69 (negative amount, there is no taxable income)

   $14,528 - $13,477.69 (depreciation amount from #4 above) - $36,449 (interest paid)= -$35,398.69

7. There is no taxable income on this investment. It produces a paper loss of $35,398.69.

8. $14,528 (No taxes are owed on this cash flow)

9. Deprecation would be higher if it were a residential investment property.

10. -$43,398.69 (negative amount, there is no taxable income)

    4000 x $14 = $56,000 gross rent

    $56,000 - $5,000 (expenses) = $51,000 (NOI)

    $51,000 - $44,472 (mortgage debt) = $6,528 (cash flow)

    $6,528 - $13,477.69 (depreciation) - $36,449 (interest) = -$43,398.69

SCENARIO #2

1. $135,000

   2,600 sf (restaurant) x $25 = $65,000

   1,500 + 2,000 = 3,500 sf x $20 = $70,000

   $65,000 + $70,000 = $135,000

2. $114,455

   $135,000 - $20,545 = $114,455

3. $1,144,550

   $114,455 ÷ .10 = $1,144,550

4. The comparable sales are important to know. However, the value is based on the amount of income and expenses.

5. $23,477.95

   $1,144,550 x .80 = $915,640

   $915,640 ÷ 39 = $23,477.95

MAILBOX MOO-LA.com

After only seven years of real estate investing, Brian Patton was able to support himself and his family solely from the income produced by his rental properties. At the young age of 37, he retired from the day- to-day grind of a 9-5 job. His only job now… to collect the money from his mailbox.

"I handed in my resignation to my boss with such a relief. Mostly a relief that I had finished what I had dreamed of… to use my mind to create freedom for myself and my family."

Take it from a guy who has done it and discover how you can:

- Create Consistent Cash Flow
- Cut Your Taxes
- Pick Out the Right Property
- Make Financing Work ***for*** You
- Leave Your Day Job

About the Author

Brian Patton, CCIM, is a successful real estate investor and author. He has a degree in land planning, a former career in zoning and development, and is presently the CEO of a highly successful commercial real estate brokerage firm. He lives near Atlanta, Georgia with his wife and three kids.