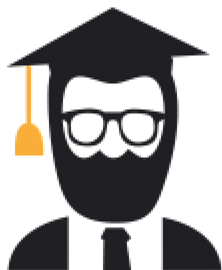
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GET THE SCOOP ON...

Looking at positive and negative economic factors ▪ Hanging on in survival mode ▪ What affects your market ▪ Planning and balancing your investments ▪ Identifying risks and opportunities ▪ Diversifying your portfolio ▪ Building a reserve ▪ Shortening the length of your loan payback time ▪ Watching for the signs of change ▪ Analyzing the building ▪ Investing in your investment ▪ Knowing which properties are performing and which are duds ▪ Assessing your strategies

Chapter 16

Surviving the Peaks and Valleys of Real Estate Investing

Every business has cycles, and the successful investor plans ahead. It is easy to love the renewal property business when things are going well and hate the business as it gets more challenging. Remember the lessons of the Great Depression, the energy crisis, and September 11, 2001, and stand ready to live up to the adage, "When the going gets tough, the tough get going!"

Reviewing potential economic impacts

There are a number of economic impacts that could positively and negatively impact your rental business, and each is discussed in the following sections.

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Employment opportunities in your area

Consider the largest employers in the vicinity of your rentals. Is there a healthy diversity in the types of industry that are the mainstay of the economy in your chosen investment area? Learn from and remember the impact of booms and busts like those of the oil industry in Texas, the steel industry in the Ohio Valley, the textile industry in the Southeast, and so on. What would you do if your rental business were located in the neighborhood closest to Enron's or WorldCom's headquarters?

Specialized entities include higher education, the military, and a concentration of government jobs. These sectors frequently expand and contract with broader economic currents as public funds and public preferences change. If a military base were to close or a vast number of its service people reassigned due to war, could your rental-property business survive?

Having investment properties around a university appeals to several investors whose children are now heading to college. Remember that this type of rental is seasonal, however, and usually will require more maintenance and has higher turnover.

Some communities are only for 55+ age bracket. These people may be more stable residents, so find out about the trends in the area you are buying. If this is a favorite retirement area, it may be a good investment.

Supply and demand of housing in your area

There is typically a three- to five-year lag time between the time developers propose housing projects and subdivisions and the time these communities are ready for occupancy. Conversely,

Bright Idea

Consider joining your local chamber of commerce and get involved with the housing committee. Pay attention to what the businesses are doing in the area where you own your investment property. Your local chamber of commerce usually is active in the business community.

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there is a lag time between the time these homes are ready for occupancy and saturation (the homes all being filled). Is your business ready to grow from high demand/low supply, and can you make it through the tough times when demand is low and supply high?

Interest rates

In 2003, interest rates hit their lowest point in 40 years, thus producing a window of opportunity for tenants to become homeowners. Just about everyone who could qualify — and some who probably should not have qualified — converted from the rental market to the home-buying market. Are you ready for riskier tenants and higher turnover if this happens again?

Environmental issues

Bad things can happen no matter how well prepared you are. How would you like to have owned investment property near Three Mile Island or the Love Canal?

Proceeding with caution

If you have not dropped this book off the nearest bridge or run screaming from the room, you are probably well suited for the real estate investment business! Just remember that the absolute key to success in any endeavor is to take calculated risks. This means achieving a level of understanding to identify risks and opportunities and planning for long-term prosperity.

So what do you do?

- Pay down your highest rate loans first.
- Buy smart.
- Don't overleverage yourself.
- Diversify your portfolio.
- Watch for the signs of change.
- Use consistent policies and procedures.
- Reinvest every time you sell a property.

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- Build a reserve.
- Re-evaluate strategies.
- Constantly evaluate the performance of your properties and get rid of the duds.

The following sections explore each of these ideas in detail.

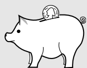
Pay down your highest-rate loans first

Some investors strive to pay down mortgages more quickly than the original terms of the notes. If you choose to do this, target your highest-interest-rate notes first to save money in the long run. In times of economic weakness, you may think about refinancing the term to lower your monthly payment. You can always pay more principal and shorten the term of the note when the market recovers.

Buy smart

Everyone has an opinion about purchasing investment property. As long as you know there is no cookie-cutter approach, you are ahead of most investors. Cap rates, gross rent multipliers, and return on investment calculations are extremely valuable, but there is more to the total equation.

An analysis of the building includes the structural integrity, present and deferred maintenance needs, aesthetic appearance, functionality, and features and benefits. A financial performance includes rental history, including vacancy rate, turnover rate, cap rate, and finally, the return on investment. An economic analysis includes the political and social forces and the local economy, including crime rates and demographics.



Moneysaver

Do your homework before you buy. Consider the property's atmosphere, buildings, and financial performance. Atmosphere includes the location, neighborhood, demographics, crime rate, and the economic base. Real estate is all about location, location, location. Make sure to take a good look at the entire area in which the property is located.

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Do the research necessary so you know where to invest. Ask around, talk to other investors in the area, drive around the immediate area to see what the neighborhood is like. Good research takes time. Maybe you know the neighborhood is not the best at this time but expect to hold the investment in hopes that it will turn around. As the new owner, many times when you begin improving your property and other investors see that, it starts a trend.

You can tell a lot about the building and the neighborhood by the condition and number of cars around the property. If you see a lot of cars that are run down, old, beat up, and on blocks or look to be non-operational, it is usually a bad sign. Also, are people just hanging around? Is there trash littered on the sidewalk, driveways, and lawns? One approach is to find out the names of other owners on either side and ask to meet with them to discuss a plan to fix up the neighborhood and bring up the quality of tenants.

Visit the local police department and introduce yourself. Let them know that you are a new owner and your goal is to improve the property and to bring in quality tenants. Find out whether they have any recommendations, as some will give you safety tips from a police perspective. Some communities have a program that is in sync with the police department to clean up a neighborhood. The owners and tenants of the properties get together to plan clean-up days, watch groups, and social activities to support one another and keep the neighborhood one they can be proud of.

Decide your goal in owning investment property. It may be to provide housing for your parents or other family members for a short while, and then turn it into a rental. Perhaps it is to help clean up a neighborhood that has your interest. You may want a tax write-off to maximize the bottom line for more income, or it may be to buy that retirement home now that you plan to move into three to five years from now. The type and location of property in which you decide to invest needs to meet your ultimate goal.

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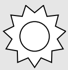
Remember that it is okay to take a risk; just know what you are getting yourself into. Negotiate well and prepare for the worst-case scenario.

Don't overleverage

You may have seen paid TV advertisements where a real estate guru tries to sell you a product that will teach you how to make money with no money down. Sounds great, right? After all, if you have nothing at risk what do you have to lose? The answer is your credit rating, income from your primary job or other investments, and possibly even any other assets you own. Fully leveraged investments have no room to absorb economic swings, maintenance projects, vacancies, or any other hidden cost. Downpayments are a good thing.

Lenders have learned over time and experience that they need to protect their investment in your property from failure. The banking industry requires mortgage insurance on any loans exceeding an 80 percent loan-to-value (LTV). They recognize the higher risk associated with a highly leveraged (low down payment) property. Making a loan at 80 percent or less LTV will ensure the success of the bank's investment most of the time. Many institutions are now requiring 25 percent down on multi-family properties or non-owner-occupied properties, so be prepared.



Bright Idea

Research state and local government laws regarding rental property management, because these vary greatly from one area to another and definitely affect your bottom line. Find out about business licenses, property taxes, special tax assessments, rent leveling calculations, and other laws, as well as restrictions concerning landscaping, exterior color schemes, parking, curfews, and so on.

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Watch Out!

If your property is leveraged to the maximum and the market takes a turn and rents decline, or you suddenly have long-term vacancy you mayy experience financial hardship. Be prepared, as rental markets go up and down based on many factors.

When you have selected and analyzed the available properties and have identified the top two or three choices, take a few minutes to think negatively about what would happen to your investment if rents dropped 25 percent or the largest nearby employer were to move its operations or close down completely.

Diversify your portfolio

One strategy for minimizing the effects of a downturn in the economy is to diversify your holdings. As you choose new investments, consider the advantages and disadvantages of each new purchase. Single-family homes and duplexes tend to sell more quickly than multi-family units. Multi-family units however, have the advantage that if a unit sits vacant for a month, you still have some rent coming in. As you build your portfolio, maintain a mix of properties to reap the benefits of each type, while at the same time minimizing the negative effects of economic changes.

In my portfolio, the modest single-family home has statistically out-produced all other types of investment property time and time again. This is attributed to the fact that there is a housing food chain, where the vast majority of tenants begin in a small apartment and move up into a larger apartment, then into a duplex, then into a small single-family home, and then into a larger single family home, and continue renting homes until

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they are ultimately ready to purchase a home. This natural progression is a result of our quest for more space, more privacy, more bells and whistles, more status, and so forth. This is perfect preparation for the responsibilities of owning a home, which is the ultimate American dream.

Another important consideration in diversification is location. The rule of thumb is that you should not manage rental properties that are more than a one-hour drive away from your home or work because it is too time-consuming to show available units, monitor them properly, and perform maintenance in a timely manner. Within your one-hour radius, though, choose properties in different locations to minimize the effects of business closures, natural disasters, and so on. If you do decide to purchase outside of your immediate area, be sure there is a good property manager you can hire if needed (see Chapter 17).

Watch for the signs of change

The recent recession is frequently attributed to September 11, 2001. However, the economic downturn began long before that date. Early warning signs of a recession include falling interest rates, irregular stock market changes, job layoffs, overbuilding, fewer inquiries from people moving in from another state or location, tenants moving because they need to save money, and so on. You can keep your finger on the pulse of economic changes by watching the newspaper for an increasing number of ads for similar rentals, price changes on similar units, and headlines in the news about changes in jobs and the economy, and by tracking the length of time it takes to get your vacant units rented.

Most small investors and management companies are very slow to change. You can beat the competition by watching for trends and being creative in attracting the best tenants. In a slow economy, investors lament that they cannot afford to take less for

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a rental unit. However, choosing the wrong tenant or holding out at a high price only increases the problem. The faster you turn your vacancy, the more stable your cash flow will be.

Being in a group of other investors can really help because you aren't on your own to do all the research. You also receive input from others on the trends they are experiencing.

Use consistent policies and procedures

Tenants with poor credit, job instability, questionable landlord references, or criminal histories are turned away from most savvy investors and managers. They frequently look for a private individual from which to rent simply because they cannot get by the qualification process, and typically, they are relegated to paying higher rent as a result of their risk. However, I cannot stress enough how important it is that you set firm qualification guidelines, and then stick to them consistently. Not only does this strategy protect you from lawsuits alleging discrimination, it also keeps you steady in difficult times.

When interest rates recently dropped to the lowest rate in 40 years, tenants evolved into homebuyers at record numbers. In fact, the only tenants left in the market were the ones who could not qualify for a mortgage, and I even saw some tenants qualify for loans whom I had refused to rent to! Even as I saw this mass exodus of tenants, I set firm policies and adhered to them faithfully. If you allow yourself to get desperate and begin accepting any tenant standing upright with green money, your risk multiplies.

Reinvest

Look around your community. Are there poorly cared for areas? Do you see run-down houses, duplexes, or apartment buildings? Do you ever wonder how this happens? Is it just that properties are old?

It is likely that you are seeing rental properties either owned by investors who are in trouble or owned by someone with a

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philosophy to bleed a property by doing only the minimum maintenance required to keep the property producing income. These investors are also known as slumlords, and they make a lot of money on their investment until the property is sold or bulldozed.

Research in inner cities has shown that if there is graffiti on a building or a broken window that is not repaired immediately, it quickly attracts more abuse. If it is repaired immediately, it is less likely to be vandalized again in the same immediate time period. Whether or not you care about your buildings will be readily apparent, and you will attract the positive or negative by your choice in maintenance philosophy.

> "Plan to keep your properties for a long period of time to obtain the highest rate of return, while at the same time planning for the ups and downs of the market."
>
> —Susan A., MPM (master property manager) investor and property manager

Protect your investment by monitoring it frequently. Enforce the lease and if there is damage, mandate that the tenant repair it, or repair it yourself and charge the tenant immediately. Get rid of tenants who display a chronic tendency to disrespect your property and their neighbors, or cause negligent damage. Don't allow your property to attract only the poorest-quality tenants.

Quality properties attract quality tenants. If you reinvest in your property by keeping it aesthetically pleasing outside and inside, you will be better prepared to survive and thrive in a down market. As you reinvest, focus first on the curb appeal and second on interior aesthetics. It will not matter how beautiful your property is on the inside if prospective tenants drive by and are turned off by the outward appearance. Cultivate and maintain a clean, manicured, and colorful exterior, and you will out-compete other landlords for the best tenants, even in slow times.

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Build a reserve

Plan for upgrades and hidden problems by building a reserve. Just when you think everything is going along nicely, either some major expense comes up or a few of your long-term tenants give you notice to move. You need to plan and be prepared. If you have long-term tenants, you will usually endure a great deal more of expenses, as you will need to upgrade the unit at the time of their move-out. There are several methods for calculating an appropriate reserve to be used for capital improvements and economic changes.

Start by developing a spreadsheet that lists:

Item	Remaining Life	Replacement Cost	Reserve Needs
Roof	10 years	$2,300.00	$230.00/year
Paint	4 years	$1,350.00	$337.50/year
Carpet	5 years	$985.00	$197.00/year
Linoleum	2 years	$375.00	$187.50/year
Appliances	8 years	$1,100.00	$137.50/year
TOTAL ANNUAL RESERVE REQUIREMENT:		$1,089.50/year	

This type of calculation is called the full funding method and will assist you in determining how much money you need to set aside each year to be prepared for replacement costs. In order to keep this calculation current, you have to reinvestigate replacement costs every year. The advantage to using this method is that you will always have the funds immediately available as needs arise. The disadvantage is that you will not be able to leverage that money (that is, spend it) if you are true to your funding plan.

The baseline method uses the same basic calculations, but it trims down the amount required by graphing out cash flow needs so that the funds will be available when needed. The basic

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premise is that the reserve fund only needs to be large enough to cover expenses as they arise and not drop below a targeted minimum.

Year	Project	Funds Needed	Contribution	Expense	End Balance
2005			$650.00		$650.00
2006	Linoleum	$375.00	$650.00	$375.00	$925.00
2007			$650.00		$1,575.00
2008	Paint	$1,350.00	$650.00	$1,350.00	$875.00
2009	Carpet	$985.00	$650.00	$985.00	$540.00
2010			$650.00		$1,190.00
2011			$650.00		$1,840.00
2012	Appliances	$1,100.00	$650.00	$1,100.00	$1,390.00
2013			$650.00		$2,040.00
2014	Roof	$2,300.00	$650.00	$2,300.00	$390.00
TARGETING MINIMUM RESERVE: $500.00					
ANNUAL RESERVE REQUIREMENT: $650.00					

These are the simplest analytical methods to use to determine the level of reserves you should have on hand. Of course, you could just set a policy of x number of months operating and debt service costs. Whichever method you choose is up to you. However, you need to understand the importance of maintaining your properties so that you attract the best tenants, even in a down economy.

Re-evaluate strategies

As markets change, you need to be flexible to change with them. Sometimes, a change in the market necessitates a change in the policy. I decided to accept tenants who showed some risk.

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At this point, I created at a policy that I would conduct an interior inspection 30 to 45 days after the tenants moved in to see whether they were good caregivers. Even when tenants know you will be there and clean up for you, a smart landlord can still see whether there is a problem just by looking in corners and under the sofa. Any tenants I identified as having poor property-care habits were immediately flagged for quarterly inspections. Any damage found during inspections was addressed then and there by giving the tenant seven days to correct the problem or be charged for the repair.

Always assess what is working and what is not. Think about the ways to manage the risk and set written policies to address the risk. Being consistent is absolutely crucial, but ignoring trends is certain failure. Set yourself up on an annual schedule of reviewing policies, preferably in mid- to late- May, before the busy summer moving season.

Evaluate property performance (and get rid of the duds)

When you sit down in May to evaluate policies, also evaluate the performance of each of your properties using the same analyses as when you decided to purchase. Compare returns on investment, look at vacancy rates, and obtain information from your Realtor about comparative properties for sale. Meet with your accountant to discuss your tax status and how your investments will improve your position. Is your property producing as it should or would it be wise to sell or exchange it? Always treat your rentals as a business and make good business decisions. Some landlords get personally attached to the properties and lose sight of the bigger picture of the investment.

Opportunities are everywhere. If you miss out on what may have been a great deal, don't give up. The right real estate agent will keep contacting you with everything on the market until your needs and/or goals are matched with the right property.

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Don't buy if the property doesn't feel right. Take your time when you are in escrow to be certain this is the right investment for you and that it all makes sense. Better to change your mind before you purchase the property than after, when you are knee-deep in large expenses.

In summary, there are cycles in real estate investing: times of feast and times of famine. Nothing is insurmountable, but there will be times when the going gets tough, and you will need to be tough enough to get going. Savvy investors do their homework before buying and manage risk throughout their ownership by staying current with economic cycles and trends. They respond to change quickly, clearly, and consistently, and prepare ahead of time for the worst. By doing so, everything else in landlording is a nice surprise!

Responding (or Not) to Market Swings

Suppose the rental market is on the rise after you've been struggling for the last two to three years to make ends meet and maintain the property. The normal reaction is to make the same rent adjustments with your tenants as you hear others are doing. This is not the time to be increasing your rents to your steady tenants. Remember that you are in this for the long run and a good tenant is still worth keeping.

On the other hand, rents may be trending down. Don't wait for your tenant to come to you to ask for a rent decrease — go to them. They may not come to you because they may be out looking for a better deal. When you find out, it may be too late. Keep in mind that a turnover costs money and is lost rent revenue.

The market swings are a time for your long-range planning to kick in. Don't just be reactionary.

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Just the facts

- All rental markets change, so watch for the signs and be prepared.
- The successful investor plans ahead.
- Keep aware of employment changes in the area of your investment.
- Evaluate what building booms are doing to your property.
- Most banks want at least 20 percent down, if not 25 percent. Overleveraging is not a good idea and can cause financial hardship if the rental market takes a downward turn and there are many vacancies.
- No money down is very risky.
- Diversify your type of investment property.
- When you build up your equity, continue to reinvest.
- Quality properties attract quality tenants and both attract more quality tenants.
- If you plan to pay down your loan/mortgage, pay down the one with the highest interest rate.
- Continue to analyze your strategy.
- Think about and write down your goals in owning investment property.
- Join organizations such as the local chamber of commerce so that you stay current on the employment changes, companies coming in to the area, and perhaps even new building or development that is coming to the area.
- Protect your investment by sticking to your policies and procedures.
- A good plan includes building a reserve for emergencies.
- Get rid of the properties that are problems. Get rid of the duds.

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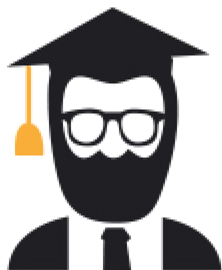

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