

How to buy real estate in the crazy times of 2009.

Other investors and I have used this method to purchase hundreds of homes in the Chicago land area. The best part is that this method works even better when the market turns, and the media is telling everyone that banks are not lending.

I have broken this document up into eight sections that describe in detail how I have bought multiple properties. These eight steps have all been a vital part of the process. Personally, I have been investing in real estate since 2001 and have seen incredible changes in the market during this time. In just a few short pages, you will be able to benefit from my years of experience and start out ahead of the game. You will be able to skip some of the mistakes I made a long the way, and be that much farther ahead of the most investors.

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Have funding secured for the deal

This just might be the most important step. You can have the perfect house scoped out, but obviously, without the proper funds, it will go to the next investor. To be sure that you are able to purchase the properties that you want it is vital to have

You might hear a lot about no money deals, but look closely at the title of this section, it says funding, not money. Think of all possible funding opportunities. There are always other options outside of your own personal checking account. If you are having trouble financing your deal, you are either talking to the wrong people, or more likely, the deal is not a good one.

Double closings, assignable contracts and other similar deals really only work for a small number of deals these days, if any. To gain access to a greater number of deals, you must have some sort of funding available to make it to the closing table. I personally choose to select from a larger number of properties and pick the best one, rather than picking from a select few, just to find out that none of them will meet the rest of my criteria to purchase. Even worse, I have talked to people that purchased a home because it was the only one that met their strict financial constraints. So ultimately, they had a property, but it did not meet all of their purchasing criteria (purchasing criteria is discussed in greater detail in section). In the end, they got into a bad deal, because they did not fully explore all of their funding options to start with.

Talk the talk, then walk the walk. Know the lingo of your lenders, if you are working with a private lender, know which documents are customary to sign to get that type of financing, if speaking with a commercial lender, you better know terms such as debt coverage, LTV, etc... Funding comes with trust, and when you speak the same language, you will make a good first impression.

Lets talk about one method of funding for a bit. Cash! You may of heard, cash is king, right? Well it is. Period. Does that mean that without cash, you are dead in the water? No, but the competitor with cash is going to probably get the pick of the litter.

Have a reputable and experienced contractor interviewed and ready

Almost any property that you pick up for 50 – 70% of fair market value is going to need some improvements. Period. Now there are reputable, honest and experienced contractors out there, but there are also a lot of undesirable ones too, unfortunately they do not necessarily come with a warning label.

First, look for a contractor that does something similar to what you want done. If you hire a custom home builder to do a turnover between renters, I doubt you will get the best value. Similarly, a local handyman might be overwhelmed with a major rehab requiring a lot of specialized sub contractors. Both are a poor fit for their talents.

In fact, many bad contractors are good people that do not know how to run a business, manage multiple crews, etc... You need much, much, much more than someone who can say "I know how to fix that.", you need someone that can deliver, like "I will have this done by this Friday and it will cost \$230 and I will send you an invoice payable net 30 when I am done." I must also note here that a good portion of disputes with contractors is poorly defined requests by the homeowner/investor. Your version and their version of "Just fix it" can be widely interpreted. Don't blame the contractor if they do not read your mind.

Therefore, when selecting a contractor, give them an example of what you will provide them, such as a punch list, legal contract, lien waver, payment terms, etc...

Also during the interview period with a new contractor, look for the subtle things such as, are they responsive, prompt, and do they follow through. If they take too long to get you a quote back, there is a chance it will take them too long to do the work for you (and this is when the house is costing you money).

In conclusion, follow these simple rules, and you will start off like a pro...

Find the right contractor for the job

Make sure they follow through, with everything (even the little stuff).

Set expectations up front (for the job, and how much communication is needed)

Find the right distressed property

You might think this would be the first step, right? Not at all, just as you need the foundation before building a home, you need the base steps before signing a contract to buy a home, especially an investment property. You should also know what you plan to do with this home, what your exit strategy is and how long you plan to keep it.

I buy distressed homes for many reasons. First, they are almost always priced below market value, even when accounting for costs of rehab. Second, I have build relationships with banks to help me fund these deals. Third, I have build relationships with rehab crews to improve these homes and maintain them.

This does not mean that all distressed homes are good values! Just because it sold for \$210,000 in 2006 and now it is \$160,000 and distressed does not necessarily make a good deal. In these crazy times, I only use comps from the past 6 – 9 months AND use the income approach to value to confirm that those comparable home sales will result in a profitable investment. For example, I have a friend that bought a piece of land for less than half of what similar lots were selling for. After he got done bragging to me on what a great deal that he got, I asked him a simple question: “How much is someone going to pay you to hang onto that piece of land?” He replied, “Nothing, but I got a great deal.” I replied, “Sure you did, but if you pick the right property, you can get a great deal, AND have someone else pay you for it, AND have extra money coming in each month.” So basically, he found a good deal relative to comparable sales, but when valuing it with the income method, it came up quite short. This analysis up front could have helped his focus. Let me tell you about a conversation that I had with another friend who wanted to purchase a home in their upscale neighborhood. This home was being offered for much less than its peak value during the summer of 2006. Back then, it sold for \$749,000 in very nice condition. My friend could get it for \$480,000 and it needed about \$20,000 worth of work, to get it back to retail condition. My friend was very proud of this incredible deal and was waiting for my applause, or for me to drool over this great deal. I mean, he found an easy \$249,000 worth of equity, right? Well... Before I could make any judgment, I needed to ask a few questions. So I started with “What are similar size and condition homes going for in that neighborhood right now?” He looked up with an expression of someone being asked a question that he knows he should have a solid answer for, and reiterated “Well, back in 2006 it sold for bla, bla, ...” So I asked 2 other questions, “What do you plan to do with it AND what is your backup plan?” He replied, “Sell it for a good deal and move on to the next.” So I asked again, “How long can you afford to hold on and wait for a buyer?” Again, that expression materialized... Now for some background

What terms can you get a loan for?

What is the property worth based on recently sold comparables?

He says that he will put down 20% and finance the rest at 7% APR over 30 years. Pretty standard deal, right?

I do some quick searches and find recent comparable sales, and in my best opinion, this home would *list* for \$600,000. This means that I would start asking for this price. So I pulled out some paper, a calculator and sketched out the numbers of this deal.

Purchase: \$480,000
Rehab needed: \$20,000
Annual Real Estate taxes: \$8000
Estimated After Repaired Value: \$600,000

Loan Terms: \$384,000 @ 7% APR over 30 years with 20% down payment

So taking this information into account, I calculate the following numbers:
Cash invested in this deal: down payment of \$96,000 and rehab of \$20,000 for a total of \$116,000 (assume closing costs are rolled into the loan)
Monthly payment for loan, taxes, and insurance: \$3380/month
Estimated Equity: \$100,000

So looking at these numbers, right away you are thinking \$100,000 in equity is pretty nice, right? Well, lets look a little further before committing to anything.

So now you have \$116,000 in cash tied up and have to come up with nearly \$3400 every month just to hang onto this house. Assume it takes 2 months to complete the rehab and it takes 6 months to sell this home (4 ½ months to list it and another 1 ½ months to make it to the closing table), what would the estimated payout become?
As we planned we list the property for \$600,000 and after 4 months get a actionable offer of 96% of list price at \$576,000.

Sale price: \$570,000
Realtor fee: -\$28,800 (assume 5% fee)
Holding costs: -\$20,400 (mortgage, insurance, taxes)
Closing costs: -\$2000 (these can vary widely depending on your area, but just for
Loan Balance: -\$382,000 (you paid down the mortgage a couple of thousand during this time)
Initial Investment: -\$116,000 (your down payment and rehab money)

Approximate Net Proceeds: \$20,800

Now, looking at this, your first reaction is that \$20k is a lot of money, right? Sure it is, but what risk are you taking to get it? Just like big banks have been given “stress tests”, lets stress test this deal for a minute and see it flat lines or keeps going?

What are your risks? Risk #1, It could take a while to get a buyer, buyers that have \$600,000 to buy a home do not grow on trees. There are many homes in this price range in this area that are on the market for close to a year or more. With this house costing you \$3400 per month and only making \$20,800 if things go well, if this sits on the market for an additional 6 months, you would be dangerously entering not just a zero return, but

paying someone else (out of your pocket, well actually out of your down payment) to buy your fixer-upper.

Risk #2, the market could continue to soften and you will have to reduce your price from what you originally planned. \$20,800 on \$600,000 is only 3.4%, so if you were to drop your price around 3%, you again enter that bad investment. One thing to remember with real estate, the market does not care what you have invested in a property or how much you need to sell it for to break even or make a profit. The market pays the going rate, PERIOD.

This is sort of a side note, but if this deal works as planned, you will be taxed on the net proceeds at the short term capital gain rate versus the much lower long term capital gain rate.

Now after all of this, I have not completely dismissed this deal. I still have another question: "What is your backup plan?" And I lead a little by asking "what do homes in this area rent for?" By checking local rental listings and calling local leasing agents that specialize in higher priced rentals, we determined you could rent a home of this size for about \$2800 per month. We also determined that it would take longer to find a tenant, since there are not many tenants at this price range, so we need to factor this in as well. So once again, we go back to sketching out some numbers:

Rental Income: \$2800 / month

Expenses: -\$3400 / month

Cash flow: -\$600 every month.

Now this is a lot better than bleeding \$3400 every month, but still less than desirable, and you still have \$116,000 tied up in this property! Another thing to note here is that it could still take multiple months to find a quality tenant at this price range and that would be costing you \$3400 every month the place is empty. Now I can dismiss this deal... My point was clear, what seemed like an easy \$100,000, could easily turn into a financial drain. That is mainly why you do not see the "flipping" that was going on, their business model was merely subsidized by an over inflated market!

After deflating my friends dream, I offered a solution. I said that you have the right idea, you just need a version that works in all markets, even near the bottom of 2009. What if I could show you how to acquire \$600,000 worth of real estate, have much less, if any, money into it, and have it pay you \$1200 every month, and have positive equity. Interested? I get a bewildered "yea... How?"

I answered "Simple, similar to your original plan, buy distressed property at a discount, but make sure that your purchase price plus the cost of improvements needed is less than the max loan amount that you can get from a bank (usually 75% to 80% LTV). Then check local rental rates and calculate the net cash flow, just like before. Make sure this number meets or exceeds your targets. (I look for about \$300 after taking into account mortgage, taxes, insurance, maintenance, and vacancy factor).

The property must meet ALL of these criteria before I even think of making an offer. So he asks, "Where did you come up with \$1200/month and \$600,000 worth of real estate?" I respond with "In my local market, currently homes that retail sell for \$150,000, and rent for about \$1200. By buying the distressed undervalued properties and fixing them up, my investment in the property is less than \$120,000 and therefore I can get a loan for my initial investment and get my money back to do the next deal. This leads to the next step of repeating this process to acquire \$600,000 worth of property. Now about the \$1200/month, assuming a loan of \$110,000 at current rates, my monthly expenses are no more than \$900, giving me at least \$300 per property. Again this repeated 4 times is about \$1200 per month. And that's not all, if you have a property worth \$150,000 and have a loan balance of \$110,000 and all of your original money back out of it, you have about \$40,000 in equity per deal. If that was not good enough, here is the best part of all, when done right, your rental income will pay down your mortgage balance over time. The longer you hold it the lower your loan balance becomes. Again, back to the numbers:

Lets say that you bought 4 homes and have an \$110,000 mortgage on each of them. 4 times \$110,000 is \$440,000 at 7% interest after 5 years, you loan balance would be about \$414,000. \$26,000 has been paid with the rental income, not to forget the \$72,000 in positive cash flow that you have received over that time, plus appreciation of the properties. Now after 25-30 years, and I have many friends that are in this position and loving it, your mortgage debt will be zero, and most of your rental income goes right into your pocket (and you have not touched your principle). I see this as making good money today, and great money in the future.

Now some might argue that location is the first criteria for purchasing a property, and yet I have not mentioned it explicitly here yet. If you read between the lines of what I type, you will see that I search for properties that meet financial criteria and then focus my attention on those locations. I do look for recovering neighborhoods and I stay away from areas that are really rough. Speak with local real estate agents to get an idea of what blocks are bad and which areas are OK.

Manage the Closing

Up till now, it was a lot of motherhood and apple pie. Now lets talk about a few of the details. At closing (the point where you take ownership and you officially sign for the property, loan, etc...), you should understand the details of the loan documents that you are signing. You should have had a chance to review the documents and get a copy of the HUD usually a day before you are scheduled to close. An attorney experienced with representing clients that purchase distressed property comes in very handy. For this, I could provide a few great names, or suggest you to go to a local real estate investors meeting and ask around. Since many of these properties are sold as-is, it is squarely on your shoulders to do due-diligence.

Just like all other service providers, there are good and bad title companies. I have had the best luck by selecting a title company that is familiar with your lender or attorney.

Rehab and Improve the Property

Now we are going to build on section 2 of this article and talk about improving a distressed property. This is an important step and gets many people nervous about getting into a distressed property, that is why I break it into separate sections. Now, I love equations, so let us look at this simple one.

Distressed Property + Improvements = Comparable Retail Property

Simple right? You would think so, but many people get this wrong! Remember when you evaluated your purchase, you used comparable sales to estimate its after repaired value. You should have an idea of what these homes look like. Take some time to schedule some showings of homes in the area that are in retail condition. Take notes of things like kitchen size, how modern are the appliances, cabinets, flooring, lighting? Does the comparable have brand new carpet, and or new paint? How about the mechanicals such as furnace and air conditioner? Does the house have circuit breakers or older fuses? If these questions do not make sense to you, then bring a friend that does or have a home inspector come with you. Take notes on these things and this becomes your punch list for the home that you purchase. If the comparables have ceramic tile and your house does not, you better have that improved if you want to achieve that value. Again, you do not need to be an expert on laying tile; you just need someone on your team that can do it for you.

Many of the people think that if they spend twice as much time or money on the improvement, it will result in higher value. While details are very important, your goal is to target the comparables that you have chosen.

You can keep this very simple by keeping this in mind. If your comparables have a new roof, your house should have a new roof. If they mostly have ceramic tile floors instead of vinyl tiles, your house needs ceramic tile floors. Get it? If your comparables have vinyl tile, will you get an acceptable return on your money if you do marble tile? NO. Period.

Now here is a point that contractors love, listen to your contractor. They have many valuable ways to mutually save money, assuming they are experienced. There is nothing wrong with working smarter. For example, I have all of my homes painted the same colors on the inside. That way when a room needs freshening up, I simply call or email a request to paint, and I do not have to worry about finding the paint color, ordering just the right color, or paying the contractor to manage that. We both save money and TIME. Remember that in this line of work, you get rewarded for results, not how many hours you put in. So it is your best interest to resolve problems quickly and efficiently. For more on this, read "The 4 Hour Work Week" by Timothy Ferriss.

You will benefit by specifically listing a "punch list" of what you want fixed or improved, and reviewing that with your contractor before, during, and after the job. Your contractor might resist at first, but will soon welcome the chance to collaborate. Before signing off that your contractor has completed everything, I like to go through with your punch list room by room and check things off. Make sure the plumbing works, run the shower, flush the toilet, etc... Remember, it is better for you to find the problems rather than your tenant or buyer.

Rent the Property

You have done your homework, picked the right financing option, chose a good contractor, found the right property, improved it with the help of your contractor, and now you are going to hand the keys over to someone else to live there? YES, just like all of the other steps, you can do this right or wrong.

I could write a whole book on this subject alone, here are the important points to remember.

1. Attract quality prospective tenants.
2. Show the property
3. Screen the applicants
4. Sign the Lease
5. Set expectations of your tenants and yourself
6. Strictly follow the terms of the contracts that you both sign.

To attract quality tenants, you need to advertise and let people know that you have or will have a home for rent. There are many ways to get this done, from placing a sign in the front yard, to having an agent market on your local MLS. When speaking to prospective tenants, describe the house and the price, this will narrow down your applicants to those specifically interested in what you are currently offering. Now you have a focused market to show the property to. After showing the property, you offer an application for them to fill out if they are interested. I ask for an application fee to add another filter to prospective tenants. At this time, they become applicants, and the screening begins. We use tenant verification services to perform credit checks, eviction history, and criminal history. This is an easy tool to use and can be done quickly and accurately.

Once you have chosen your tenant, it is time to sign all of the necessary paperwork. This includes a lease, property disclosures, and writing down any additional agreement between the owner and tenant.

Now that you have written documentation to go from, it is easy to set the expectation from this point forward. Simply explain that both sides are going to adhere to the lease exactly as spelled out in the documents that you signed. If either of you stray from that course, it will have adverse consequences for both parties.

Now simply follow the process that you both agreed to in writing. This means when a maintenance call comes in, you respond to it within the time that you set up front. If they are late on rent, you start moving forward with the eviction process. Period. Even if they have a great excuse, they will be motivated to pay you first if they have an eviction looming over their head, where as if they have a free pass until next month, your bill goes to the back of the line and the next month their problem is suddenly twice as big! Therefore, so is yours...

Properly finance the property

Congratulations, now you own an income-producing asset! From most bankers' perspective, this is a crucial step toward lend-ability. Similar to how a bank will lend a machine shop money to purchase a lathe or machine center because it is an asset that makes you money, your house is an asset that makes you money, therefore you can get a loan from a bank at an affordable payment to free up some or all of your initial investment.

If the real estate crash has taught us one thing, it is that any property that you buy must have positive cash flow and extra equity. So when you look at financing or refinancing your initial investment (cash, hard money loan, construction loan, etc...), into a longer term loan, make sure to keep your loan principle balance and terms to support positive cash flow month to month.

If you rehabbed the property properly, bought it at the right price, you should not have a problem borrowing the amount of your initial investment and having your tenants pay it back, with extra to spare. The key here is to use a mortgage calculator or spreadsheet to calculate what your monthly payment would be based on current rates and on loan amounts.

Manage the Property –

If you have made it this far, stick with me, this is important. It is not really hard, but still no less important. By properly taking care of your tenants, you are going to get the best from them. This does not mean driving by their house every day, or calling them to make sure they are still employed and the house is OK, it just means setting the expectations and meeting their needs. If you do not respond to their issues or you treat them with disrespect, they will not want to stay, or take care of your house. Long term rentals with low turnover are the name of the game! Most of our tenants sign up for multiple renewals because we manage the properties well. There is a time where you treat someone with respect and do not receive it in return, but by and far, it works out very well for most relationships. As I mentioned in the previous section, set the expectations and follow through. If a tenant does not hold up their end by not paying rent on time, or properly maintaining the property, you must take action quickly on them. Once you set the expectation, they will either shape up or move out. I consider that a win-win situation.

Repeat...

I make this its own section because once again, it is very important. Here is a time, where if one is good, two is better, and so on.

In closing, I offer all of this information to you without any obligation, but I also want you to know that I have teamed up with the From Wrecks to Riches Team and can offer everything listed in this article when you purchase through our group. We have been doing this process for many years and bought many hundreds of homes in the Chicagoland area. We have banks that offer incredible financing and will pre-approve you for homes based on your financials, we have excellent rehab crews that know exactly how to do everything from hauling away trash from a home, to rewiring or replumbing an entire home. And of course we find the RIGHT properties. Not only do we find the right properties, we close on them for significant discounts because we buy all of our properties with CASH. With our experience, we know and can determine the rental rates, comparable values, and rehab needed to ensure that the house you choose will be a wise investment. And of course, if you started to loose me when I was discussing property management, finding tenants, and all of those other technical details, it is not a problem. We have a team of leasing agents AND property managers that can get you qualified tenants and handle all tenant requests for you. It is pretty amazing to find a group of people that will help you through this very apprehensive process, but that is exactly what we do.

Send me an email if you want to hear more about this. I would be glad to take you through some of our homes that we have recently acquired, and ones that we have recently rehabbed and are ready for rent to show you first hand examples of what we do on a daily basis.

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