Property Investing Tutorial

BBB ACCREDITED BUSINESS | A+ rating

SINCE 2005

Alex Schauffert
Broker/Owner
DRE#01216432
Since 1996

newstandardrealty.com
alex@newstandardrealty.com

Call Alex today!
(707) 332-8301

NEW STANDARD REALTY

REALTOR® EQUAL HOUSING OPPORTUNITY

Table of Contents

Common Industry Terms

Gross Scheduled Rent: The total annual rent to be collected if all units are occupied

Gross Rent Multiplier GRM: The asking price of a property divided by the gross scheduled rent

Capitalization Rate CAP Rate: The annual profit as a percentage of (divided by) the purchase price

Return On Investment ROI: The annual profit as a percentage of total cash invested - Used when financing.

Placement Fee: A management company's charge to provide and place a tenant.

Schedule E: The section of a tax return showing the expenses and profit or loss of rental property.

Deferred maintenance: repairs immediately necessary to bring a property being purchased up to good operating condition.

Pro-forma: When selling a rental property, the imaginary rent that could be collected under ideal circumstances

Estoppel: A document signed at time of sale by both the tenant and landlord stating when the tenant moved in, their current rent, what date they are paid through and their security deposit. One estoppel per tenant.

Capital Improvement Slush Fund: A capital improvement is something that increases a property's value such as a new roof. If a roof cost $30,000 and is expected to last 30 years, even if the building has a brand-new roof, $1000 per year should be set aside so the roof can be replaced in 30 years. This thousand dollars is considered "capital improvement slush fund" money.

General Advice

Single family homes are more liquid (easier to sell) but multi-unit properties offer a better cash flow return for dollars invested.

Never trust anyone else's calculations for CAP Rate or ROI (return on investment.) Crunch these numbers yourself. There are tutorials on it in the following pages.

Vacancies Happen. Vacancy can be actual or financial. If a unit is tenant occupied but they stopped paying rent, it is physically occupied but financially vacant. For purposes of CAP rates and your financial wellbeing, only financially occupied units count.

Never buy a property without thoroughly inspecting it first. Have professional inspectors inspect the home. Check to see the home matches the tax records for size and # of bedrooms, bathrooms, # of units and land usage. Discrepancies could mean un-permitted apartments, additions or renovations.

Keep and exercise your right to thoroughly inspect a property after you have an accepted offer. This needs to be done prior to releasing your inspection contingency, which can happen by action or time lapse, depending on the contract.

Be wary of a seller's records showing exceptionally low maintenance expenses (under 8% annual average) unless it's a relatively new or refurbished building. This might simply suggest a lot of deferred maintenance.

Be wary of higher than expected rents without one or two years IRS schedule E's to show a history of such. Sometimes landlords fill vacancies with tenants who have bad rental histories at exorbitantly high rents to make the books look good when selling a property. "No credit check and first month free," will attract tenants willing to agree to pay above market rents for below standard housing. A little forensic bookkeeping such as rent rolls and leases going back a few years will help if the seller is unwilling to show their Schedule E's.

"Rental property needs tenants." Yes, but you cannot always assume rental demand tomorrow because it exists today. I suggest contacting the City Planning Department of any city you plan to purchase rental property in. Find out if the population is increasing, decreasing or stagnant. I recommend you buy in cities where the population is increasing or creditably expecting to increase.

Not following rental laws can cost you more money and headaches than you can imagine so be wise and obey rental laws.

General Advice

Buy in the path of progress.

In stagnant economic times and stagnant population growth times, residential property can be rented by lowering the rent if necessary. Not so with commercial property. A perfect example is an obsolete strip mall that can sit vacant for years.

In declining population areas, SELL, unless you know a reason the population will return.

"Believe half of what you see and none of what you hear" comes from an old Gladys Knight song. It's a pretty good rule. There can be a lot of smoke and mirrors with regards to a rental property's advertisement of profitability. If you are a seasoned pro, you know this to be true. Let me help you as I have helped numerous investors profit from real estate.

"PROFORMA" The term "Proforma" in real estate advertising means "it's not currently happening but maybe it could." I often think, "If you really could be getting those higher rents, why aren't you?"

Management is not free. If you do it yourself it will cost you time and money and a little heartburn.

Check leases and estoppels during your inspection. To confirm rents and security deposits are as advertised.

Visit the neighborhood on Friday & Saturday night. Rif-raff comes out at night.

Advantages & Disadvantages

Advantages of rental property
Excellent source of residual income - Numerous tax write-offs - Invest with leverage using the banks money - A strong hedge against inflation as property values often outpace inflation - Rents go up as years pass - Eventually the property is paid off – Can be mostly managed by a professional management company

Disadvantages of rental property
Added responsibility - More decisions to be made **-** Possible confrontations with unruly tenants if self-managed - Inevitable repairs - Government restrictions on rental policy, eviction policy and rent increase policy (Government rental laws should be strictly adhered to.)

Learn the laws that govern tenants' rights and or contract a professional property management company. They typically charge about 8% of the gross rent collected which includes placement fees. In my opinion, worth every penny!

Multi-unit Properties

DUPLEXES through FOURPLEXES and 5 OR MORE UNITS

Advantages of 2, 3, and 4 plex (unit) properties are:

- They offer a HIGHER rental income compared to a single-family home of comparable cost.
- The rent collected from 2- 3- and 4-unit properties is considered when qualifying for the loan. This means you'll qualify for a more expensive property.
- If you intend to live in one of the units, then FHA guidelines could apply. This allows buyers to purchase with the least down payment, as little as 3.5% of the purchase price. There are even loans (called FHA 203K) that allow the purchase of homes that need extensive work. That means they finance the purchase of the property and the needed repairs also.
- Since you can buy a more expensive property, because the rental income is considered when qualifying for the loan, when values go up you'll make a larger profit. When rents go up, you'll make more profit due to having multiple tenants / rents.
- They're somewhat safer because if a tenant stops paying rent you will still have the other tenants to collect rent from while dealing with the issue. In the case of fourplexes this is referred to as "standing on four legs".
- Due to higher rental income, you can afford to have a professional property management company manage the property for you.

Disadvantages of multi-unit properties.

There are government restrictions on how much and how often rents can be increased. This can make it somewhere between difficult and impossible to bring rents up to current market value if they are significantly below current market value.

Advantages of Properties Greater than 4 Units

Typically, only purchased by professional investors which means the competition (other buyers) will rarely bid the purchase price high. They typically sell at higher CAP Rates so even if financed, offer a better return on investment, ROI.

Disadvantages of Properties Greater than 4 Units

Loans to purchase these properties are harder to qualify for and often need 25% or more down. At 15 or more units there must be an on-site property manager.

Buying Rental or Income Property

Rental property is a long-game financial move, responsible for **most of the wealth most wealthy people have.** Picking the right property and managing it well are your responsibilities. I'm highly experienced. Please reach out to me and let me assist you.

Important things for the beginning investor to know:

Population growth or decline in any given city will affect the future demand for rental housing.

Laws regarding tenants' rights are taken seriously in a courtroom. Screening of potential tenants, housing requirements, increasing rents and evictions all have governmental rules and restrictions. I highly recommend you both learn and follow them. My personal favorite is to contract a professional property management company to deal with this for you.

Leases the tenants currently have in place, survive the sale of the property and must be honored.

Avoid areas with a: high percentage of vacancies, high percentage of foreclosures, high percentage of abandoned properties, high percentage of boarded-up homes. These are all signs of investors who tried and failed in these areas. Bustling areas with none of the above are where investors tried and succeeded.

Learn how to read if a property will be profitable or not.

Anticipate Profitability

"Believe half of what you see and none of what you hear." A line from an old Gladys Knight song rings true when shopping for rental property.

The Gold Standard of a property's profitability is the owners schedule E's on their annual tax returns. Often, sellers are reluctant to show you this. So, a simple and conservative way to calculate the potential net profit a property will yield prior to buying it, is to multiply the gross scheduled income by 57% then subtract any bank interest you will pay for a loan. This is not an absolute, but allowing 43% of the gross scheduled rent for overhead is a reasonably conservative and a safe calculation of what to expect. Once you're experienced, you should do a little better than this, getting closer to 60% of your gross scheduled rent being profit. This 43% of gross scheduled rent for overhead allows for: vacancy, management, maintenance, taxes, insurance and other miscellaneous expenses.

Calculate deferred maintenance costs as part of the purchase price, that you should have in reserves, when purchasing a property.

Disclaimer: *The above is not absolute but is a very good conservative approach to predicting profitability.*

Factors affecting a rental property's net income:

- **High maintenance and / or high tenant turnover** can bring expenses to over 43% of gross scheduled rents. Low maintenance, low tenant turnover and self-management can drop expenses to under 30% of the gross scheduled rents.
- **Properties converted to multi-units** versus properties designed as such can incur more maintenance costs.
- **Older properties** can incur higher maintenance costs.
- **Above average rents** for a property's location, size, condition and amenities often leads to vacancies, one of the largest expenses a landlord can have! Vacancies not only don't collect rent they incur the additional expense of apartment refurbishing costs. Check with local property managers and rental evaluation websites if the advertised rents on the property you wish to purchase seem a little high. Click here for an automated rental evaluation.
- **Vacancies** in a property you're considering buying can be a sign of the rents being too high or issues with the building or neighborhood or poor management.
- **Potential code violation issues or potential litigation.** A good property inspection including due diligence with city planning and code enforcement and properly executed estoppels and should thwart most of this.

How Much To Offer

How much should an investor offer when buying? There are many factors and this is subjective, however, the following, though not absolute, is valuable information for a novice.

Supply and demand / comparative method: Look to see how much every home of comparable size, amenities and condition, within 1/4 mile, has sold for over the last few months. If it's a multiunit property compare duplexes to other duplexes and four-plexes to other four-plexes (of similar size, condition and bed / bath configuration). If more than four units, determine a per-unit value and use that to compare.

Income producing method: Try to purchase a property with a **CAP Rate** close to and preferably at or above current financing rates for that property.

From both the comparative and income adducing method, subtract the cost of deferred maintenance and vacancies.

Based on the above, establish a value and add or subtract 2% or more, depending whether in a sellers' or buyers' market. That's what I would do.

Remember, yours might be one of several offers and the sellers need a reason to pick yours. Also, sellers see a cash buyer as more likely to close than a financing buyer. This being said, finance buyers often need to outbid cash buyers to look attractive to sellers. There are other nuances to make a financed offer more attractive such as being over qualified for the loan and having more cash than necessary to close if the appraisal comes in lower than expected.

Calculate CAP Rate

This is the annual % profitability of your purchase/property.
Please do this yourself and DON'T take the seller's word for it.
If you can get a recent schedule E on the property, take the information from there, but if not, the following is a reasonably decent guideline.

Start with the gross scheduled rent (the total scheduled rent to be collected annually).
Subtract all vacancies (should not be more than 5% to 7% of gross scheduled rent (+/-)).
Subtract the cost of maintenance and capital improvement slush fund (10% of rent (+/-)).
Subtract the cost of taxes (average 1.25% of your purchase price annually).
Subtract the cost of insurance (check with provider as sometimes rates increase the property is sold).
Subtract the cost of management and placement fees (typically 8%).
Subtract the cost of legal fees, advertising fees and other miscellaneous expenses. (3%+/-).
Subtract the cost of landlord paid utilities such as PG&G, water and / or garbage. Ask for utility bills for these.

The total of these expenses typically add up to 43% (+/-) of the gross scheduled rent so the NET annual income should be at or near 57% of the gross scheduled rent. Some commercial property leases have the tenant pay for taxes, insurance and maintenance. This is called a triple net lease or NNN lease. So, when calculating your CAP Rate, only subtract expenses the landlord is responsible for. Divide this final number by the purchase cost (which should include all purchase expenses including purchase price, closing costs and deferred maintenance).

FORMULA

FICTICIOUS EXAMPLE:

$950,000 property with $8333 monthly income
CAP Rate Example and Estimate:
Given a four-plex that cost $950,000 + $10,000 in non-recurring closing costs and $40,000 in needed repairs (a total purchase cost of $1,000,000) and rents for $2,083 monthly per unit x 4 units = $100,000 per year gross scheduled rent.

$100,000 "annual gross scheduled rent". Now subtract from that…
-$5,000 (5% for vacancy, a reasonable expectation)
-$6,000 (6% management fee on collected rents)
-$2,083 (placement fee = 1 month rent every 4 years per "ballpark")
-$8,000 maintenance (8% of rent) +/- depending on age and condition of the property & quality of tenant
-$11,875 estimated annual property taxes
-$3,000 estimated annual insurance
-$3,500 annual utilities (depends heavily on who is responsible for water, garbage, PG&E)
-$2,500 legal, surprises and miscellaneous
($41,958) total of all expenses is subtracted from gross annual rent
=$58,042 net profit.
$58,042 divided by $1,000,000 (Total Purchase Cost) = .058 or 5.8 CAP Rate.

That's an annual return of 5.8% or in industry terms, a 5.8% CAP rate.

If you managed the property yourself you would save the management and placement fees of $6,000 and $2,083 ($8,083 total) giving you a $66,125 net profit for a 6.6% annual return or CAP Rate. You can also save on maintenance if you do some of that yourself.

Calculate ROI

Use ROI or return on investment, if you have a loan. Total the down payment, closing costs, costs of immediate needed repairs and cost of tenant placement if there are vacancies. Divide the annual net profit (collected rents minus expenses and bank interest) by your total purchase cost you will get your "Return on Investment" or ROI.
Note: The principal portion of your payment is considered profit.

Fictitious Example:

$950,000 property with $8,333 monthly income
$950,000 purchase, 25% down= $238,000 down payment,
add $10,000 estimated closing costs
\+ $40,000 in needed repairs
= $288,000 total purchase cost

$100,000 in annual gross scheduled rents
Minus $41,958 in total annual expenses
= $58,042 net annual income for first year
Minus $56,880 annually ($4,740 monthly on $712,500, 30-year loan at 7%)
= $1,162 positive cash on cash return BUT…
Add $7,238 the 1st year principle paydown and…
$8,400 = the first-year return on investment, ROI
$8,400 ÷ $288,000 total purchase cost = .0292 = 3% ROI

This ROI number improves with time as rents climb and the principle paydown increases annually. Calculating a scenario with 3% annual rent increases and a standard amortization schedule, on the 10th year of ownership, the above scenario property would net over $95,000 annually including principal paydown. The ROI for the 10th year would be 33% (+/-) and 35% ROI (+/-) on the 11th year so on.

Selling a Rental Property

Price the property using the comparative method or income producing method whichever is higher, then add 5% for wiggle room.

Tenants often get scared if they think the property is selling. They often don't understand that their lease survives the sale. Sometimes landlords prefer not to post "for sale signs" on the property. On 1-to-4-unit rentals I prefer to speak to the tenants and explain to them what to expect.

Only prequalified buyers should be allowed to view the property. Most sellers allow the viewing of only one unit prior to accepting an offer. Upon acceptance of the offer, during the inspection time, the buyer is allowed to view the other units.

If selling a vacant rental property, even if only one apartment of many is vacant, consider painting, landscaping and staging as part of the marketing of your property. This will allow the property to be shown in its best light and allow you to suggest the highest possible potential rent, called Pro-Forma rent. This beautiful look will help convince the potential buyer of the possibility of the Pro-Forma rent you suggest.

The property should be listed on MLS in every surrounding County and on Loop Net for maximum exposure.

Buying Property To Flip

I have helped numerous investors acquire many properties to flip. However, with the current uncertainty of the economy, uncertainty of interest rate direction and uncertainty of future homeownership demand, I **would caution any flippers** to only acquire properties that can be flipped quickly and to accept the potential liability of having to sit on the property for a long while or resell it at a discount if the market turns down.

Fixer-uppers offered for sale at a cheap price attract many investors. You will be competing with investors offering all cash and quick sales.

Maybe you can spot a property that typical investors miss. I once bought a tract home with a water view from outside the home but no windows on that side of the home. Three windows later I owned a home with a water view that was worth significantly more than when I purchased it. Another idea, pocket doors are very old school but often are structurally framed for openings near twice the size. Open them into a large archway for a more modern look. A barren backyard can be made to look warm and inviting with very few dollars spent on bark, pavers, some shrubs and tasteful patio furniture. (The furniture you will take with you at close of escrow.) If you plan to keep the property for a few years, plant some trees. They will increase the desirability of the home when you sell it.

Calculating a flip Take the estimated future sale price of your property and subtract 10% of that future sale price for buying, selling and cost of money expenses, subtract the estimated cost of renovations, subtract the minimum pre capital gains tax profit you wish to make and that is the most you can pay for the property.

Example:

A home that should sell for $700,000 after renovations

-$70,000 (10%) buy/sell expenses,

-$60,000 in proposed renovations,

-say $75,000 minimum pre-tax profit

= $495,000. It is the most you should offer for that property

1

If You Are Not A US Citizen

It is legal to purchase real estate in the United States if you are not a US citizen. Most non-US citizens pay cash because getting a mortgage here will be difficult without US tax returns and a US social security number.

Reasons to buy US, California, real estate:

1. True land and building ownership
2. Financial Investment
3. Student housing for your child
4. Rental income
5. Appreciation
6. Vacation home
7. Future housing
8. Develop housing for profit
9. Get a Green Card with the EB-5 Immigrant Investment Program

---

2

Using IRA Funds

Under many circumstances, rental property can be purchased with funds from your self-directed IRA account. As with all retirement accounts, the rules are strict but can benefit you with great tax savings.

I have no affiliation with these firms but give them a try for more information on the subject
Equity Trust
Provident Trust Group

Also GOOGLE the IRS and self directed IRA's. I'm sure there are other firms providing such services.

NEW STANDARD REALTY

Alex Schauffert
Broker/Owner
Since 1996

DRE #01216432

(707) 332-8301
Alex@NewStandardRealty.com

BBB ACCREDITED BUSINESS
A+ RATING
Since 2005