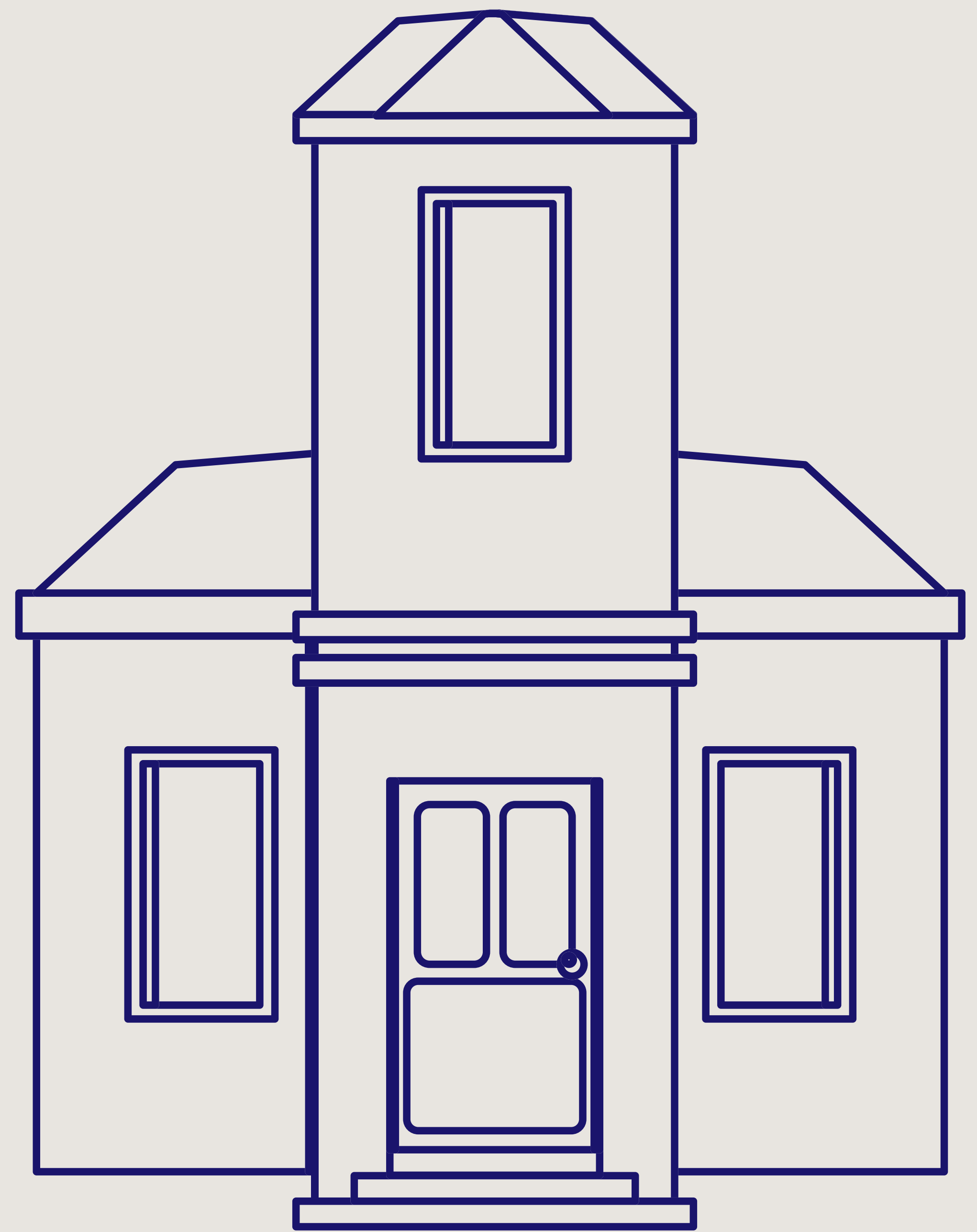
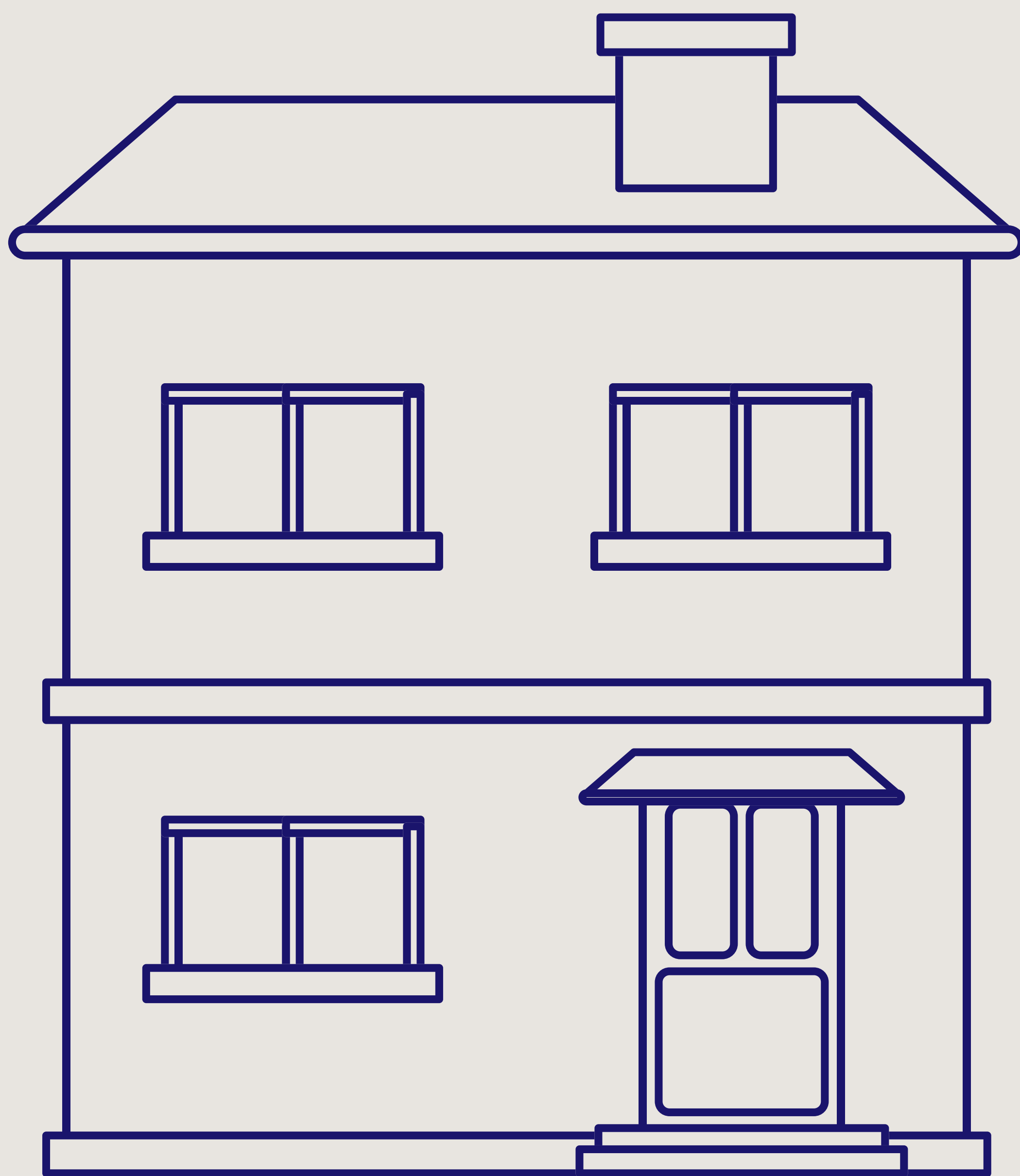

Guidebook for a First-Time Real Estate Investor

COLDWELL & HOCK

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If you are considering taking the plunge into real estate investing, congratulations! You will be joining an auspicious, prosperous club. Real estate—that is, land and the buildings on that land—has been linchpins of wealth since the Feudal era.

90% of all millionaires become millionaires thanks to real estate investing. Millionaires and billionaires who made their fortunes in other ways invest in real estate to give those fortunes longevity.

This guidebook covers the basic principles a first-time real estate investors needs to understand to start purposefully looking for his or her first investment property.

What to Look For in a Property

A good investment starts with a good property. However, many newcomers misunderstand what constitutes a "good property" for investment purposes. Some newbies will buy any property because it seems like a "good deal," responding to societal noise that real estate is always a "good investment."

Many successful real estate investors got started this way … and made painful mistakes, learning hard lessons that they applied to their next property purchase. With an intentional approach to finding the right property, you could avoid some of these early mistakes and increase your chances of making a good buy right off the bat.

RULE #1: Invest with your head, not with your heart!

Home is where the heart is, so we tend to buy our homes with our hearts—a beautiful new-construction home with a huge backyard; a gourmet kitchen; a peaceful street in a gated community; a condo close to the action …

These kinds of properties may make great homes, but they often make disappointing investments. When you look for an investment property, **forget about whether you would love to live there.** You're not shopping for your dream home, and in fact your tenants are probably not looking for their dream home—just the right place for their budget and their circumstances.To start property-shopping with your head instead of your heart, it is important to understand how real estate investors **grade properties** and **grade locations.**

Property Grade

Real estate investors often give a property a "letter grade" between A and D. This will work together with a similar grade applied to the location to determine what investment strategy might work for this property (if any).

- **"A" Property.** New construction, fully updated with modern amenities expected by a high class of tenant. Little or no "deferred maintenance" (i.e. routine maintenance that has been ignored and could lead to costly repairs if procrastinated).
- **"B" Property.** 10-20 years old, maybe a little outdated but still very acceptable to discerning tenants. May have some deferred maintenance, but not too much.
- **"C" Property.** 20+ years old, outdated and possibly "functionally obsolete" (too little square footage, only one bathroom for three bedrooms, etc.) Probably some deferred maintenance.
- **"D" Property.** Significant deferred maintenance, property barely habitable.

Location Grade

A nice house is all well and good, but as you may have heard, real estate is about "location, location, location." Investors will assign a property a "location grade" as well as a property grade.

- **"A" Location.** Affluent, "hip," or otherwise desirable location. Usually an infill area (mostly built out, not a lot of vacant land nearby, city center). Low crime statistics, significant urban development and investment. Might have great schools.

- **"B" Location.** Nice suburb or urban "infill area" reasonably close to the most desirable locations, good schools.

- **"C" Location.** Far-flung suburbs or working-class infill neighborhoods. May have lesser-rated schools and/or higher crime statistics.

- **"D" Location.** "Warzone," high-crime area, little city investment or police presence.

How do these two "grades" work together? Let's look at some examples:

"A" property in a "C" area. Probably a new build in a remote suburb. It might make a good "flip" property if the owner is distressed and needs to sell fast for cheap. However, if considering a "buy-and-hold" strategy, suburbs don't appreciate as fast as infill areas. You may get good tenants, but new housing developments often have other new housing developments nearby. You tenants could end up leaving for a shiny new house in the next development, leaving you with a spacious and upscale "A" property that is expensive to clean and repair.

"C" property in an "A" area. Amazing "buy-and-hold" opportunity. They may be smaller and less expensive to renovate or upgrade, and someone will always pay premium rent to live in the "A" location, even in an outdated property. Infill "A" locations appreciate faster because the land is more valuable—not only is it closer to jobs and entertainment, there's also no nearby vacant land to build on. Tenants who find a "C" property in an "A" area may hunker down for years and endure many rent increases to keep their home.

"C" property in a "D" area. With undesirable locations, the only math that tends to work is "slumlord" math—neglectful ownership that leads to decaying property quality. This is a major reason these neighborhoods remain in a state of permanent decline. Even a "bargain basement" purchase price in a D area is probably a bad bet for a first-time investor—there's a reason the price is so low.

The Numbers—Real Estate Investing Finances

Now that you're thinking about property and location grades like a pro, it's time to think about **real estate finances** like a pro.

Remember Rule #1—smart investors invest with their heads, not their hearts. Even an ugly property, or a property in a remote location, may still be a good buy if the numbers tell you it's a good buy.

How Much is your Property Worth?

Most real estate investors do not pay "full price" for their properties. Think of homes for sale in new developments as having a "heart markup"—a little extra that a family will be willing to pay because they love the gourmet kitchen, or the yard has lots of space for Spot.

Real estate investors may sell at a "heart markup," but they don't buy at one. They make their money by buying properties at a discount. To know if you are buying at a discount, you need to know what your property is worth. This will also tell you how much you might be able to sell it for when it comes time to dispose of the property.

For the purposes of real estate investing, property value may be determined in one of two ways:

- Comparable sales. Common for single-family homes, when many other single-family homes have been sold recently in the same neighborhood or nearby. You can find out these sales figures using the REALTOR MLS if you have access, or from sites like Redfin or Zillow.

IMPORTANT: Make sure you look at actual closed sales, not properties actively listed "for sale." What the "for sale" listings want for their home is not necessarily what they will get. Also, when looking at "sold" listings, look for "days on market" to see which houses sold quickly. These are the ones that were properly priced. Also account for ways in which your house may be different from the others that sold—different square footage, extra bathrooms, more upgrades, no pool, etc.

- **Capitalization Rate.** The capitalization rate, or "cap rate," is a percentage modifier used to determine the value of income-generating properties. It is usually used for apartment complexes that vary by unit number or where there may not have been recent comparable sales. The equation is as follows:

  Value = Net Operating Income ÷ Cap Rate

  Find out the "cap rate" for properties in the asset and location grade by doing google searches, contacting a commercial real estate broker, or doing the math yourself based on recent sales. If you discover that an appropriate cap rate is 7%, and the property has a net operating income (income minus expenses, not including any mortgage payment) of

  $49,000, the math is as follows:$49,000 ÷ 0.07 = $700,000

  According to this cap rate, the property is worth about $700,000.

  You can also use cap rates to work backward. If 7% is a reasonable cap rate for your market, you may resolve only to buy properties with an 8% cap rate or better. In the above example, you might only want to offer $612,500 for that property ($49,000 ÷ 0.08).

Understanding "ARV"

You might hear the acronym "ARV" thrown around a lot by real estate investors. **ARV** is short for "after-repair value." This refers to the "top-dollar" value of the property after any and all deferred maintenance is cured and any upgrades, renovations, or rehab are performed.

The key thing to remember is that you don't calculate your profit on a real estate deal solely on what you paid to buy the property. **Repairs and renovations come at a cost.** Additionally, purchasing real estate comes with **closing costs**, like title insurance, appraisal fees, and legal fees. Moreover, selling a property usually comes with its own costs, like REALTOR commissions.

All of these costs matter when evaluating a real estate deal. If you bought a house at $200,000 and sold it for $250,000, it is too simple to say that you made a $50,000 profit. If you bought the house for $200,000, paid $5,000 in closing costs, spent $20,000 on renovations, and paid a REALTOR $10,000 in commissions to sell the house for $250,000 … then your actual profit is only $15,000.

Worse, if you budget $20,000 for renovations but they end up ballooning to $40,000, you have lost $5,000! Home flippers also have to budget in carrying expenses like short-term vacant-house insurance and usually several months of mortgage payments.

This is why many home flippers try to buy substantially under ARV. They might multiply the ARV by 85% or even 70%, subtract the expected repair budget, and that is the maximum they will offer on the house. The way, if repairs go over budget, they have a cushion of safety to still make a profit.

For example, if a property has a **$400,000 ARV** but needs $40,000 in repairs, the investor might multiply the ARV by 70% to get $280,000, then subtract the $40,000 in repairs and determine that his or her max offer on the house will be **$240,000.**

As you can see, this is an offer substantially below market value! But a motivated seller might take it, especially if the property is ugly or broken and no one else wants it.

Loans

Most people buy their homes with the help of a mortgage loan. This is true of investment real estate, too. The amount a lender will lend is usually based on the appraised value, and most lenders will cap their lending tolerance at a certain **"loan to value"** (LTV). For example, a lender with an 80% LTV limit will lend up to $800,000 on a property that appraises for $1,000,000.

Some lenders lend based on a **"loan to cost"** (LTC) tolerance instead of LTV. For example, if a property costs $800,000 and needs $200,000 in repairs, a lender with an LTC tolerance of 70% will lend up to $700,000 to cover a percentage of the purchase price and the repairs.

When you buy property with a loan, you are using **leverage—**taking on the risk of debt service in exchange for increased equity exposure. There are pros and cons to both types of investing. For example:

- A **high-leverage** position (a loan of 80% or more of the property value) means less cash flow and a greater risk of losing the property to foreclosure … but if the property appreciates in value, that appreciation will represent a much greater return on your initial investment.
  Pros: Potential for big appreciation profit.
  Cons: Higher risk, lower cash flow.

- A **low-leverage** position (a loan of 50% or less of the property value) preserves cash flow and lowers the risk of total loss … but any property appreciation will represent a much smaller return on the initial investment.
  Pros: Lower risk, higher cash flow.
  Cons: Les potential for big appreciation profit.

All real estate loans work in a similar way. They contain two operating instruments:

- **The Deed**, or deed of trust, which specifies the ownership of the property but establishes a lien on the deed, which entitles the lender to foreclose the property in the event of default.

- **The Note**, or promissory note, which lays out the terms of the loan itself, including the balance, interest rate, term, amortization schedule, etc.

Investors have several different options for obtaining loans:

- **Traditional Mortgage.** Most mortgage lenders also lend on investment properties. The lender will look carefully at the borrower's personal credit and income and less at the economic potential of the property. Whereas mortgage lenders will accept a 90% LTV for loans on a primary residence, most limit investment loans to 80% LTV, requiring a bigger down payment.

- **Private Loan.** Many real estate investors like to lend their cash to other investors. They will usually offer a higher interest rate and a shorter loan term, but may take the economic value of the property into account.

- **Hard-Money Loan.** These lenders typically loan on "fix-and-flip" projects. The loans are short-term and high-interest, but may cover most or all of the purchase and repairs with interest-only monthly payment terms. The idea is that the seller will sell or refinance within a few years.

- **"Subject-To" Purchase.** Some investors buy properties "subject to" the original financing. This means that the deed changes name, but the note remains in the seller's name—in other words, the original mortgage stays in place. Most sellers would only agree to this if they are behind on payments, in danger of foreclosure, and the investor offers to make them whole in exchange for buying the property at a fire sale price. Mortgage lenders have the right to call the note due if this happens, but if the investor keeps making the payments on time, many lenders don't bother. It would be more expensive for them to foreclose.

Appreciation or Cash Flow?

Investors usually reap a return on their investment in one of two ways—**cash flow** or **appreciation.** The best real estate investments produce both returns.

Cash Flow

If a property earns more money from tenant rents and fees than the expenses it incurs—including the mortgage, property taxes, insurance, repairs, utilities, marketing, management, etc.—it has **positive cash flow.**

If you divide annual cash flow by the cash you used to buy the property (including the down payment, closing costs, and immediate repair budget) you have a metric called the **cash-on-cash return.**

For example, if you put $30,000 down on a house, paid $5,000 in closing costs, $15,000 in repairs, and made $4,000 in positive cash flow for the year, you made 8% cash-on-cash return for that year — $4,000 ÷ ($30,000 + $5,000 + $15,000).

You can compare the cash-on-cash return to other investments you might have made. Do the mutual funds in your IRA earn you an 8% annual return?

Pros of Cash Flow:
- Recurring income.
- Easier to attain with lower leverage.

Cons of Cash Flow:
- Low-leverage, high-cash flow strategies yield less appreciation.
- Properties that have high cash flow at low leverage may not appreciate in value, meaning you may not realize substantial appreciation at resale.

Of course, there is more than one way to make money investing in real estate. Which brings us to …

Appreciation

A property owner realizes appreciation when the owner can sell the property for more than they bought it for.

Over time, real estate markets have trended upward, leading to the received wisdom that "real estate always goes up in value." **Not true**. Over a long enough timeline (10 years or more) you are likely to come out ahead. But real estate markets do take downturns. If you buy at the top of a hot market, you could wind up with a long hold to get back to breakeven. If an emergency comes up and you need to sell, you could sell at a loss.

So how *does* property gain value? It gains value if properties of that type and in that location come into higher demand. Investment properties might also gain value if they earn more net operating income (remember the "cap rate" method of valuing property?) Hence, real estate investors usually buy property with a strategy in mind to increase income or decrease expenses. By increasing NOI in some way, they increase the value of the property.

Pros of Appreciation:
- The possibility for a substantial profit, especially in high-leveraged positions.
- Low risk over long periods of time.

Cons of Appreciation:
- Gains are only realized when you sell.
- High-leveraged positions can entail more risk.

Bills, Bills, Bills—Budgeting for Expenses

Some investors look at the mortgage they can get on a property, then look at the rent the property might command. If they see that the rental number is higher than the mortgage number, they may assume that they are looking at a positive cash-flow situation.

Not so fast! The mortgage payment is far from the only expense a real estate investment will incur on a monthly or yearly basis. Every expense associated with operating a property must be taken into account before you can deduce that rental and fee income will outweigh the expenses to create positive cash flow.

Here is a more-or-less complete list of expenses you will need to account for over and above any debt service (mortgage payment) you might be on the hook for …

- Property taxes
- Property insurance
- Utilities (any gas, electric, or water bill that the landlord pays)
- Repairs and maintenance
- Administrative and professional services (accounting, legal, etc.)
- Contract services (lawn care, trash removal, etc.)
- Property management fees (if you don't intend to manage the building yourself)
- Marketing to find tenants.
- Loss of income due to vacancy.

How much money to budget for each of these expenses varies based on the market, the property class, and many other factors … but at least this list gives you an idea of what you need to budget for. Research or ask around what numbers are a good bet for this kind of property. Property managers can often help.

Reinvesting Your Cash Flow

If at the end of each month, after paying the mortgage and all the bills, you have cash left over, congratulations! You have positive cash flow! Time to book a cruise, right?

In truth, many smart investors see their real estate assets like they see their other investments. Most don't dine out every weekend on gains from their stock portfolio. These are investments in long-term wealth-building, no short-term income.

Consider reinvesting your cash flow in capital improvements and avoiding deferred maintenance. The roof has two years left in it? Don't wait until it collapses. Less deferred maintenance will help the property command a much higher price at the time of resale.

Cash Reserves

Rent is usually collected monthly, but many expenses, like insurance and property taxes, are due yearly in big lump sums. Additionally, repairs have a way of clumping themselves in big clusters. You have no repair expenses for several months, then the HVAC dies and you have a huge repair expense all at once.

If you have been using every dime of leftover cash to buy toys and vacations, you may have no cash on hand to cover these lump-sum costs. That's why it is imperative that some percentage of your cash flow —possibly a large percentage—to be set aside for these expenses. That way, when the HVAC breaks or the property tax bill comes, you have cash set aside.

For example, if you expect $4,800 in property taxes, $1,200 in insurance expenses, and $3,600 in repair expenses, that breaks down to $400 every month for taxes, $100 every month for insurance, and $300 every month for repairs. You should take all $800 of those projected expenses out of the collected rent checks and put it in a separate account, even if you don't have $300 in repair expenses that month. That way, when a $1,000 repair bill comes out of nowhere, you have cash on hand to cover it.

If you take out a mortgage to buy a property, the lender will often require payments into an "escrow account" just for these purposes. After all, the lender has a stake in the success of the investment too. After all, if the owner fails to pay property taxes, the county could foreclose out from under the lender; if the owner fails to insure the property, the lender could realize a total loss in the event of a fire; etc. The escrow account can be drawn upon when you submit tax bills, insurance invoices, contractor invoices, etc. to the lender.

Spending the Right Money Up Front

The down payment and closing costs are not the only "acquisition costs" real estate investors account for. Most plan on an initial repair budget to cure deferred maintenance, prevent hazards, and upgrade the property.

Most good investments have some defects that it falls to the investor to cure—often the seller wouldn't or couldn't cure it themselves, so they let the property go for a steal to not have to deal with it.

While the repair budget may seem painfully large, it's money well spent. Failing to spend it now may result in even bigger costs later. As long as you account for these costs up front, you can plan for them and make an offer you are comfortable with. Consider spending money early on:

Roof

Roof defects have a tendency to get costly if left unchecked, because they let water and rot into the structure of the home. Repairing or replacing the roof before it becomes an emergency will save you money up front and boost the resale value. If in doubt, repair or replace the roof.

Tree Work

Dead or overgrown trees can become safety hazards. Limbs or the trees themselves could fall on structures, property, or people. The root structures, meanwhile, could damage pipes, causing a plumbing disaster. It's much cheaper to have trees looked at and fixed now rather than later.

Gutters

Gutters that become damaged or overflow can cause water to spill into wood structures and create rot. Compared to replacing rotten wood soffits, cleaning, fixing, and replacing gutters is a steal.

Plumbing

It doesn't cost much to scope the sewer or unclog slow-draining sinks ... at least, it doesn't cost much compared to repairing a burst pipe deep within the foundation. Be wary of sewer-like smells near any of the sinks or toilets, and consider paying an expert for an assessment.

Electric

Electrical upgrades are an expense that have a way of ballooning out of control, since the electrical system is woven into the bones of the entire house. Especially for older properties, consider getting a professional assessment before you buy so an outsized expense doesn't rear its ugly head when you least expect it.

> **Pro Tip:** Make sure the electrician you consult accounts for any upgrades the city may require if you have to pull a permit. Whereas you may think a quick fix will suffice, the city may mandate an expensive upgrade.

HVAC

HVACs last forever ... until they don't. If the HVAC system is 10-20 years old, consider budgeting to replace the entire thing just to be safe. You will have to do it anyway at some point, and it hurts the least early on, when you are already writing big checks.

Renovations

Many investors make the mistake of upgrading a property to what they would like to live in. Remember Rule #1! Invest with your head, not your heart. Make sure your renovation plan matches the grade of property you have on your hands. There is no point installing 2" granite countertops in an 800-square-foot C-Grade duplex unit. The tenant will probably pay the exact same rent for the duplex unit if the kitchen has a decent composite countertop, saving you thousands of dollars.

What Asset Class Should You Start With?

First-time investors usually look at one of several types of smaller asset for their first purchase. Understanding their strengths and weaknesses can help you decide which type of property to target.

Condo

Condos may look like attractive first investments due to the lower cost of entry. After all, a condo is probably cheaper than a house of the same asset grade in the same neighborhood. However, condos have significant downsides as investments. They don't appreciate as quickly, and they are usually governed by a condo association. The association fee is an extra expense to budget for, but it gets worse—associations are notoriously poorly managed. Be especially wary if the association fee is low. If a shared roof collapses, every condo owner may be on the hook for a huge expense out of nowhere.

Pros:
- Inexpensive.
- In demand as rentals in urban infill areas or suburbs with good schools.

Cons:
- Less appreciation.
- Condo association fees.

Single-Family Home

Single family homes (SFH) are the gold standard of first real estate investments. In fact, many investors get their start by moving houses but keeping the old home to rent out. Single family homes are always in demand as rentals, especially in good areas with good school districts. They also tend to appreciate faster. However, if you lose your tenant, that house loses its entire source of income. SFHs that fall within homeowners' associations (HOA) face the same issues as condos with their associations.

Pros:
More appreciation.
In-demand as a rental and an owner-occupied home at resale.Lenders like to lend on them.

Cons:
Single stream of income—if you lose the tenant, cash flow disappears until you find another tenant.

Duplex

While technically a kind of "multifamily" property, duplexes, triplexes, and fourplexes still function like single-family properties in many ways. A duplex is a classic type of investment for a "do-it-yourself" landlord to choose. The owner will live in one half of the duplex, and rent the other half out. However, even when right next door, managing property can become more than you bargained for. As your success and wealth grow, and your portfolio balloons to five, ten, twenty properties, eventually you are going to have to hire a property manager.

Pros:
- Great "DIY" investment.
- Residential loans still available.

Cons:
- DIY property management is very time-consuming.
- Face-to-face tenant relationships can become emotionally taxing.

Small Apartment Building

While buying an apartment complex may seem like a big bite for a first-time investor, some smaller complexes may actually be within his/her price range, or within reach if the investor partners with other investors. An apartment building is time-consuming and taxing to manage, but the economies of scale make them attractive. If a tenant moves out of a six-unit apartment building, you have five other tenants to cover the bills while marketing for a new tenant. Additionally, a single-family home and a six-unit complex both have one roof apiece, but the SFH has one tenant supporting the roof-repair budget, while the comlex has six. Even if the SFH tenant pays $1500 in rent and the apartment tenants pay $500 apiece, 6 x $500 = $3,000 or double the potential rent coming in to cover repairs to that roof.

Pros:

Economies of scale—more tenants paying rent to cover the costs.
Easier to justify outsourcing property management to a professional.

Cons:

May be more expensive.
Your resale market is only other investors, not homeowners.
The value depends on increasing the net operating income.

We sincerely hope you enjoyed reading this little guidebook. We love helping our investors build and retain wealth through real estate. It's often said "you make money when you buy". While we believe this is true, we passionately believe that you RETAIN the money and wealth through *sound* property *management*.

If you are a Rentwell client we'd like to thank you for entrusting us with your portfolio. If you are not yet a client, we hope to one day join/partner with you on your investment journey.

As always, we love feedback and are looking for new ideas to write and educate about. If you have any suggestions or comments, please feel free to drop us a line.

Stay healthy and we wish you continued success in all your real estate adventures.

Rentwell Team

Your Team at Rentwell!

Our clients quickly become our friends and our residents have become landlords. We love what we do and would whole-heartedly appreciate connecting with you to learn more about your goals and interests in building your wealth through real estate.

If you're looking for advice, a partner, or sound property management services that you deserve, please reach out to us via phone call or email and let's talk!

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