by Jim Cameron

Investing in Real Estate

You've got the skills, and financing is available. You just need to make the first move

If you've been a home builder or remodeler for five or 10 years, chances are you have enough experience to spot a good price on a residential investment property. You also probably have the skills to evaluate the property's condition and to estimate the costs of any needed upgrades. Perhaps you've even been hired to renovate a building that someone purchased for investment.

As a builder, your skills and experience make you better prepared to invest in residential real estate than 95 percent of the population. This article will show you how to get started at a level and pace you're comfortable with, and will outline other skills you may need to develop.

Money Is Not the Hurdle

You don't need a lot of money or fancy tools to invest in real estate. The biggest hurdle most people face is simply getting started. During my 20 years as an investor, I've talked with many folks who want to get into this business — but few who are actually willing to take the plunge. Most people are determined to wait for the perfect building or are too afraid to put their money at risk.

And in fact you will need to take some reasonable risks. However, most investors will tell you that, no matter where you live, your money will provide an outstanding return — as long as you invest for the long haul.

Real estate is like the stock market: Despite short-term value fluctuations, historically there's been no 10-year period when the value of either hasn't gone up. That's why I seldom buy a property with the goal of making a quick buck; instead, I look for one I can improve or add rental units to. I buy and hold, collecting rent from my tenants and watching the property's value increase over time.

I made my first modest investment 25 years ago, starting as so many do with a classic fixer-upper — a single-family home in central Vermont, which I used as a primary residence. Five years later, with a partner, I bought my first rental property; I bought a second property shortly thereafter.

I purchased them as long-term investments — I hoped that they'd be a source of tuition for my two sons' education — and financed them using what was then a relatively new product, an equity line of credit that I took out on my primary home.

After that small start, I continued to learn and invest, and today I'm a full-time real estate investor with 18 rental units, a rental storage business, a six-unit condominium project, a country store, a new three-unit subdivision, and building lots

for sale in various towns and counties. My investments provide me with an excellent income and will finance 80 percent of my planned retirement.

The Potential Rewards

If you want to get into real estate investing, you should start by deciding what your goals are. You may want to create a nest egg for retirement, supplement your current income, or generate work during slow times.

Properties can be purchased either for long-term equity appreciation or for short-term cash gain. The difference is defined by how long you hold the property. Several years ago, I bought a piece of land, turned it into a subdivision, and sold off the lots the following building season at a substantial profit. That was a cash investment.

I don't generally recommend cash deals to people who are just starting out, because they're relatively risky and can have painful tax costs.

A better first effort is an equity investment. An example of this is an old barn and farmhouse I bought and renovated into a nine-unit apartment complex, and which I still own. It generates a monthly rental income and has appreciated in value over time. The equity provides collateral for a secure line of credit that I can use to operate my business (see Figure 1). It also offers tax benefits I don't get from my own home.

Calculating the Return on Investment Property

Mortgage Pay-Down

Purchase price:	$180,000
Investment:	$45,000
Original mortgage:	$135,000
Interest rate:	7.49%

15-year Amortization Schedule

Monthly payment:	$1,140
Amount of monthly payment that goes to principal:	$442
Yearly principal pay-down:	$5,304

Actual Value Increase

Net yearly income:	$6,400
Yearly principal pay-down:	$5,304
Appreciation in market value (6%):	$10,800
Total value:	$22,504

Figure 1. This financial model, based on one of the author's properties, shows the first-year gain on a three-unit apartment building. The building was bought in 2005 for $180,000 with an initial down payment of $45,000. With $5,304 paid in mortgage principal the first year and a 6 percent market appreciation of $10,800, the author gained more than $16,000 in equity. Add to that $6,400 in rental income (after expenses), and his total yearly earnings on the property are $22,504 — a 50 percent return on the original investment. While market value may fluctuate somewhat, the amount of principal paid down each year will increase.

Passive income. This is the monthly income you get from a rental property after paying the mortgage and other expenses.

The best properties have a strong positive cash flow. I consider a property a good investment if, at the end of the year, the revenue it generates exceeds its expenses by at least 10 percent.

However, if you're looking to buy your first investment property, I recommend that you not worry too much about passive income. You need to make sure that there's enough of it to carry the building's expenses, but if you wait for a perfect property, you may wait forever. The key is to get started.

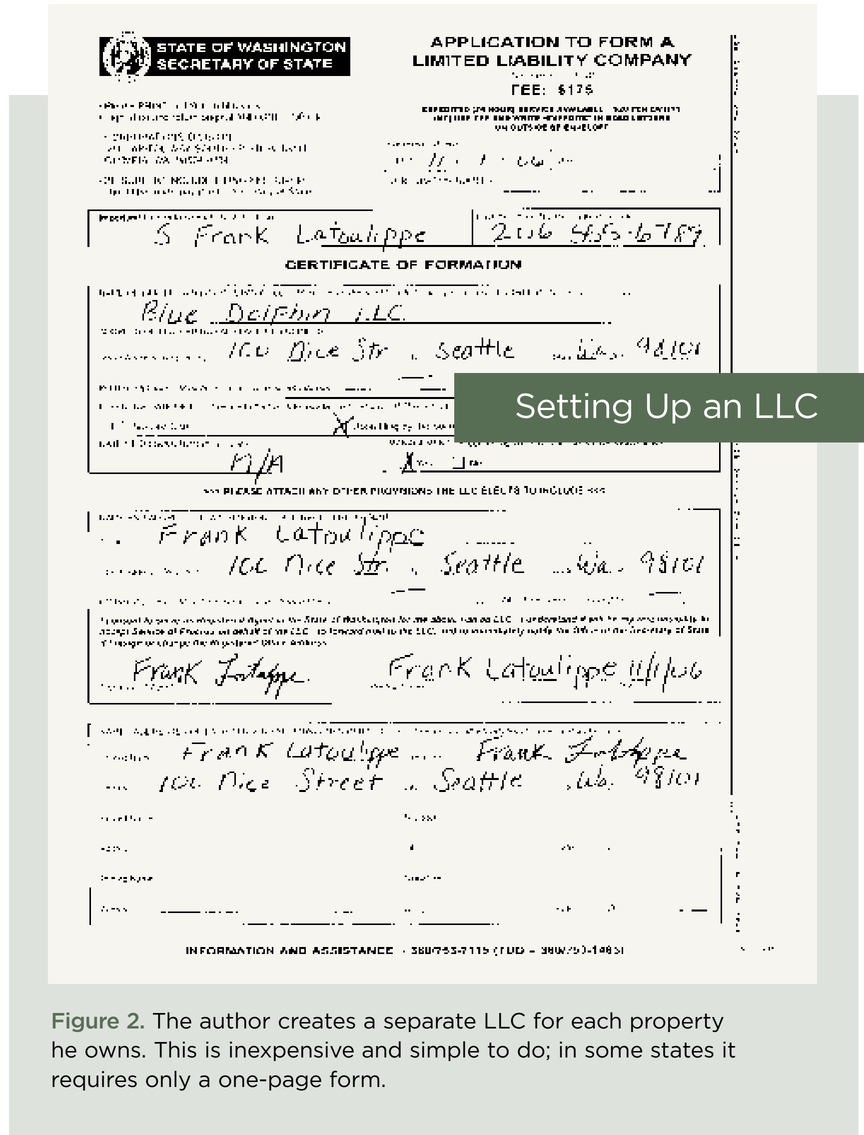
Equity appreciation. As you know, equity is simply the difference between what you owe on a property and its market value. Last year, in my part of Vermont, single-family property values increased by 16 percent. Of course, that's unsustainable, and real estate values can also drop over the short term — quite a bit more in some places than in others. But in the long run, value always grows. And as it does, so will your equity.

Keep in mind, too, that equity grows faster in an investment property than in a primary residence. That's because most investment properties are financed with commercial terms, meaning a 15- or 20-year loan. The payment is higher than with a 30-year mortgage, but you're aggressively paying down the loan and thus increasing your wealth. And this increase in wealth is paid for by your tenants.

If you hold a building for a few years, you'll probably build up enough equity to take out a line of credit, which you can then use as the down payment on another property that has better cash flow. You can also use the cash for your business.

Tax benefits. An investment property

Setting Up an LLC


STATE OF WASHINGTON
SECRETARY OF STATE

APPLICATION TO FORM A
LIMITED LIABILITY COMPANY

FEE: $175

S Frank Latoulippe | 206 555-6789

CERTIFICATE OF FORMATION

Blue Dolphin LLC

100 Nice Str, Seattle, Wa. 98101

N/A

*** PLEASE ATTACH ANY OTHER PROVISIONS THE LLC ELECTS TO INCLUDE ***

Frank Latoulippe
100 Nice Str, Seattle, Wa. 98101

Frank Latoulippe | Frank Latoulippe 11/1/06

Frank Latoulippe | Frank Latoulippe
100 Nice Street, Seattle, Wa. 98101

INFORMATION AND ASSISTANCE

Figure 2. The author creates a separate LLC for each property he owns. This is inexpensive and simple to do; in some states it requires only a one-page form.

offers the tax advantage of letting you depreciate the building and equipment. Depreciation is the notion that the building will lose some of its value over time due to age, wear and tear, and the need for upgrades (such as replacing the heating system).

Your accountant or tax advisor can help you establish a depreciation allowance for the property and its equipment. Depreciation lowers the taxable income on a property, leaving you more cash to work with.

Getting Ready to Invest

Before you even think about buying investment properties, you need to have an attorney and a commercial banker. The more properties you buy, the more you will need their services, so take the time to choose the right people.

Selecting an attorney. Most attorneys practice real estate law, so asking other businesspeople for referrals should give you plenty to choose from.

I suggest interviewing each attorney over the phone, and asking the following questions:

- How long you been practicing?
- How much experience do you have in investment properties?
- What is your experience with the permitting process?
- Is there a backup attorney in the office who can help me if you are in court or on vacation?
- What are your rates and terms?

If you like the answers you hear, the next step is to set up interviews with at least two attorneys. Focus on their experience and your comfort level with them as individuals. Assuming a comparable level of competence, it's better to enter this relationship with someone you're comfortable with.

Forming a corporate entity. I recommend creating a separate corporation for each property. If there's a slip and fall at one property, the dispute is with the entity that owns the property, not with you. This is not foolproof, but it is a good business practice.

Lawsuits follow the money, so you don't want to create paths that let someone follow them from one of your corporations to another. I prevent this by keeping separate records for each property, and by having separate insurance policies and checking accounts.

Because I want to insulate my various business accounts from one another, as well as from my personal assets, I never mingle funds. That means I never pay an expense for one project using another project's checkbook. And I don't name my wife as an officer on any of the corporations, as this would create an avenue to my personal assets.

Corporations — as you no doubt already know — come in different flavors. Although you should get the advice of your attorney and accountant on each project, when I purchase a property to hold as an equity investment, I usually incorporate it as a limited liability corporation, or LLC (Figure 2).

An LLC provides the same protection

as other corporate forms but with the tax simplicity of a partnership. Depending on where you live, creating an LLC costs only $80 to $150 and can be done with a simple one- to two-page form. It can be formed with or without partners, requires only one "manager," and has minimal annual reporting requirements. (Some properties are better served by an S-corporation, but this business structure is a bit more complicated and is best handled by your attorney and accountant.)

Working with the bank. Your attorney should be able to recommend a good commercial loan officer, but you should also ask other investors for their recommendations. The policies and practices of commercial loan departments vary by bank. Some departments are more conservative than others but offer good terms on existing properties. Others will consider financing more aggressive or even speculative projects. Yet others may loan money for multi-unit properties but will shy away from land deals that don't include a lot of owner equity.

Interview three or four candidates face-to-face and ask lots of questions. The more you ask, the more you learn and the better your choice. Ask the candidates how long they've been in commercial banking, how long they've been working in your geographical area, how many customers they have that are similar to you, and if they're planning on leaving the bank in the near future. They will tell you.

One of the most important questions

Personal Financial Statement

Figure 3. Most banks will ask you the same questions every time you apply for a commercial mortgage. The author recommends keeping your financial information updated in an electronic file; use a personal financial profile form, which is available from most banks and from various other sources, including the U.S. Small Business Administration (www.sba.gov/sbaforms/sba413.pdf). The numbers on the form shown here are for a fictitious company.

to ask is who makes decisions about the types of loans you are requesting and at what loan amount the decision process changes, if at all. Some loan officers can lend money to a set limit — typically $500,000 to $1 million — on their own judgment, but have to get larger amounts approved by someone higher up the chain.

At other banks, all applications must be approved by a loan committee. I've learned from painful experience that I would rather not do business with banks that use committees. I want to know that I can sit down and talk with the person who is going to make the decision on my application.

I've also learned that loan rates aren't always what they seem. I recently had lunch with friend who owned a building that was up for refinancing. At first, his regular bank — where he is a major customer — told him that the best rate it could offer was 8 percent. But after another bank offered him 7 percent, he called his bank back and it matched the lower rate.

The point is that if a bank wants your business and knows you're shopping around, it can be flexible.

Of course, the bank will also be evaluating you, so you need to be prepared to show why you are a good risk. For instance, the commercial officer may ask you questions to determine how well you understand the housing market, whether you're one of those people who tend to overextend themselves financially, and how much cash or equity reserve you have.

The bank will also want to know that your property will be able to support itself and that you will be able to support it if the tenants default. Assuming you are self-employed, the commercial officer will want to see three years of tax returns — your personal returns as well as returns for each business entity you own.

You will also have to fill out a comprehensive statement of your current financial situation (Figure 3, page 4). I keep all this information on my computer and update it regularly, using an Excel spreadsheet provided by my bank. This, along with tax returns, is all the information the commercial officer will need to process a loan request.

Taking the Plunge

Once you have made all your legal and financial preparations, you need to learn everything you can about your market. What areas are growing or declining? Is there a glut of rental housing, or a stable need? Are rental spaces priced per square foot or per bedroom?

You can find this information in a number of places. Read the property listings in local newspapers and real estate magazines. Think like a buyer. Know what you're looking for, what you can afford, and how far you're willing to travel.

Evaluating a Rental Property

Apts., Waterbury, Vt. Revised 7/05

Income:	Monthly	Annual
33 High St.		
33 High #I - 1 br	$475	$5,700
33 High #2 - 1 br	$575	$6,900
33 High #3 - 3 br	$850	$10,200
35 High St.		
35 High #1 - 3 br Heat not incl.	$900	$10,800
35 High #2 - 3 br Heat not incl.	$875	$10,500
35 High #3 - 2 br	$700	$8,400
35 High #4 - 2 br	$700	$8,400
35 High #5 - 2 br	$700	$8 400
Totals (both properties)	**$5,775**	**$69,300**

Expenses:	Monthly	Annual
Mortgage	$2,382	$28,584
Taxes	$512	$6,144
Water	$200	$2,400
Insurance	$143	$1,716
Rubbish	$140	$1,680
Maintenance	$200	$2,400
Advertising	$65	$780
Heat/DHW-35 High only	$235	$2,820
Totals	**$3,877**	**$46,524**

Income	$5,775	$69,300
Expenses	$3,877	$46,524
Cash Flow	**$1,898**	**$22,776**

Figure 4. The author uses an Excel spreadsheet to quickly determine whether a given property will meet the bank's requirements and satisfy his investment goals. These numbers come from two contiguous buildings he owns.

When you find what seems like a suitable property, realistically evaluate it to see if it meets your needs as well as those of the bank. I have created several Excel spreadsheets that I use as templates to quickly run the numbers on a given property (Figure 4, page 5).

A good first investment is a three- to five-unit project, as it will usually yield a positive cash flow after expenses. In some markets, the demand for housing is so strong (or real estate prices so cheap) that a one- or two-unit project will work financially. However, more units are almost always better: If you stop receiving revenue from one unit, the others will likely carry expenses.

> I seldom buy a property with the goal of making a quick buck; instead, I look for one I can improve or add rental units to. I buy and hold, collecting rent and watching the property's value increase over time.

You're also better off with a property that has units of varied sizes and with different numbers of bedrooms, so it will appeal to a wider variety of tenants.

If you intend to be a landlord, you have to approach the task as a business rather than as something you're dabbling in. You need to carefully screen your tenants and be willing to wait for a good one. And you need to have a lease that clearly spells out the terms and conditions.

If a tenant calls with a problem, you need to take care of it. This is extremely important, and I have seen many investors get into trouble by not heeding this advice. In almost every case where I've heard someone complain about a lousy experience with tenants, it was because that someone was a lousy landlord.

The critical point to remember is that tenants are customers — just like the homeowners you build for. They're paying for service, and giving it to them will benefit both of you.

You can start by upgrading the building so that it requires little maintenance. For instance, I bought two older buildings a few years ago, then totally renovated them before renting the units. Now the place is like new, and I've had no maintenance calls. The next year I did the same to another building, and I've had no maintenance calls on that one, either.

This is a key area where your experience and connections as a contractor will pay off.

Money Is a Tool

As a kid, my parents never talked with me about their money (or lack thereof); nor did they talk with their friends about it. Doing so was considered rude — an attitude that unfortunately is still very common.

Financial intelligence isn't part of our current educational system, either; most colleges have classes in economics, but they don't teach students how money works or how to leverage it.

If you want to get ahead in business or real estate, you need to acquire some financial intelligence. You can start by reading books and articles based on real experiences or research — there are any number of books out there about money. *Rich Dad, Poor Dad* and *The Millionaire Next Door* are two that helped me think about how money works and how people who have it got it and maintain it.

Do your reading with a number of questions in mind. How is money lent and repaid? What is net worth? What is the impact of personal debt vs. business debt? How do the terms of a loan work?

You should also learn how to evaluate risk. Are the risks you're taking well-thought-out? Do you have a backup plan? Do you know the difference between an appreciating asset and a depreciating expense, and can you accurately spot each in practice?

It's also a good idea to develop a relationship with peers who are willing to talk about money and how they are using it. I am very fortunate to have several investor friends with whom I can discuss money and wealth. We don't do this egotistically, but with the goal of sharing information. We share what kind of year we're having, what our tax strategies are, which banks we are using, what their terms are, and what properties each of us is buying and why.

I strongly encourage you to nurture these types of relationships. They can become one of your most valuable resources.

You should also sit down with your accountant and your financial planner at least once every six months to review where you are with your business, cash, taxes, and investments. I like to talk with them both at the same time, seeing one face-to-face and putting the other on speaker phone. The perspective I get always helps me realize new ways to maximize my cash and build equity.

__Jim Cameron__ has been investing in real estate for 20 years and has been a general contractor for 15 years. His business is based in South Burlington, Vt.