Hot Market Motivates Buyers of Cheap Rental Properties
by John V. Kamin

Lately our phone has been ringing off the hook. It seems folks are trying to buy cheap apartment buildings and cheap commercial properties. 2005 buyers are motivated to buy into these areas because of the hot-hot-hot residential real estate market. They are looking instead for other kinds of properties that have not moved up as much or so fast.

One new development for California buyers is the newest attack on Proposition 13, which limits property taxes to near 1 % of the total purchase value.

New Developments - New Attack on Prop 13

Apartment and commercial properties are marketed via Internet more than ever, versus the traditional way of brokers contacting interested prospects after listing the property.

One new development for California buyers is the newest attack on Proposition 13, which limits property taxes to near 1 % of the total purchase value. Prop 13 also keeps hikes in property tax bills limited to a 2% increase per year.

The unions and some legislators are fostering new 2005 legislation to exempt commercial buildings (and apartment buildings?) from the Prop 13 tax limitations.

Bluntly, if you bought your commercial or apartment building years ago, you probably have a low tax rate, as hikes were kept down by Prop 13. Exempting your property from the current Prop 13 tax limitation measures might mean a hike of as much as 1000% or more in your property tax bill yearly.

Another thing that could hike your property tax bill is a new 2005 purchase. Typically, when the "numbers are run", sellers and brokers list previous property taxes, from the past year or two. After purchase, property taxes will be much higher (based on higher 2005 sale price currently) which will completely change all the total expenses and cash flow and profit figures!

Bluntly, you must re-estimate property taxes, when buying a commercial or residential building in 2005 or later, what the property's new tax bill will be, and then plug in those new tax bill numbers in the expense column. It would be a terrible mistake to use the old tax bill figures, which will change the day you buy the building!

Many revolts against perpetually-hiked property taxes have surfaced in Maine, the Boston area, Washington State, and a number of other communities. Homeowner and building owners do not like their property taxes being hiked year after year as their building grows older. But that's a different subject.

Don't Overlook the Basics to Make More Money or it Will Cost You Money!

Some potential buyers who are calling us are overlooking various basic strategies. Then they ask your editor to "approve" the exceptions to our strategy as outlined in the book How to Make Money Fast Speculating in Distressed Property. Let's run through a few of the basics.

1. You want to buy cash-flow buildings, be they malls, offices, apartments or stores, within commuting distance of major metro job centers. Our cut-off point is a minimum one million permanent residents in the metro area, preferably a lot more. Since real estate is illiquid most of the time, you want to ensure a number of potential bidders, buyers and interested prospects to buy your building when it comes time to sell it.

2. What you do not want: owning an expensive building in a small town more than a one hour commute from the major metro job areas. You do not want a building where the only jobs are minimum wage, few and far between at that. Stick to metro areas within commuting distance to major job markets. Ignore the rest. Got it?

3. Don't overlook doing your physical rental survey in the neighborhood of the building you are trying to buy. How much are rents per square foot for at least three to six neighboring buildings? Your survey will determine what the appropriate rent flow for your building is. (E.G. On commercial buildings, it makes a great difference whether nearby buildings of comparable quality are renting for \$1 per square foot per month, \$2 per square foot per month or \$3 per square foot per month.)

4. Another example. The average rent for a two bedroom apartment in a decent neighborhood of L.A. (not upscale, not slum) is \$1,393 per month. But in Prescott, Arizona one and a half hours

north of Phoenix, that figure is below $500. In Safford, Arizona, three hours away, the rent is $400 for a two bedroom apartment. In Oxnard, California, one and a half hours north of Los Angeles, entire three bedroom houses can be rented for $650 to $750 per month.

So, if you try to buy an apartment building cheap, based on above-average rents in Sedalia, Missouri, or Carpinteria, California, or California City, you'd sure better survey area rentals (by doing your "rent per square foot." survey of similar nearby properties yourself) or you will be completely out of line with area rents! (E.G. In some areas, buildings rent so cheap because there is a surplus of empty buildings, empty stores, and high-vacancy rates on apartment buildings. This is basic, but seems to be overlooked even by experienced buyers.)

Don't be too lazy to do your preliminary survey or you deserve to get the nasty costly surprises. Don't try to buy a building on the internet without doing your physical area survey in the actual location.

5. We get calls from people who are trying to buy office buildings or apartment buildings who have not physically inspected the property. This is a tragic costly mistake. You need to "eyeball" the building, not the photos or pictures on the internet (where the weekly graffiti attack has been painted over for the photograph). You need to see what's what in person.

Due Diligence

Example. You need to climb up on the roof and check the condition. Virtually every building I ever bought needed a new roof or extensive roof repairs within three to 36 months.

If you don't inspect yourself or are too lazy to inspect. I predict you will get some nasty surprises soon after escrow closes.

You need to check the apartments, not just the unit showcased to prospective renters, but the actual apartments and plumbing. Run the faucets, etc. Virtually every building I have ever bought or inspected needed some costly plumbing work. You need to see what vehicles are in the parking lot, whether it's filled with old junker cars up on blocks or big trucks.

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6. Watch that cash flow (GRI = Gross Rental Income) and actually talk to at least some of the tenants and managers. This is basic. You do this before you buy, not after. You don't try to do this by emails over the internet. You need to know what the neighborhood looks like at 10 o'clock at night as well as 10 in the morning. Are residents afraid to walk around the neighborhood at night? Is it a high-crime area? You won't find that out over the internet. Was there drug activity, or worse yet, criminal violence in that building, or next door? Check it out. Again, this is very basic.

7. Watch out for numbers fraud in what I call the "buddy tenant factor". Does the present owner actually have signed leases? If so, when do leases expire? Or are 20% to 30% of the units occupied by his buddies and "cousins"; people who will move out the week sale/escrow closes? This is basic and will turn your projected cash-flow numbers upside down! Check it out yourself and know, instead of guessing from fancy internet descriptions!

8. Check expenses when you run the numbers. Can you really get landscaping for $300 year; or unit rehab for $125; or yearly trash pickup for $400? I doubt it; actual 2005 expenses may have risen 30% to 60% more.

There can be a lot of lies in the numbers. Is the owner's family doing much of the work to inflate the profits? Is routine maintenance being deferred to cut expenses and pump up cash flow, profits? Often, there's a lot of cheating going on. As in nuclear disarmament, you trust but you must verify every number.

9. My basic strategy is to buy when everyone hates property, not when everyone loves it. You are at or near the top of the cycle 2005-2006 (more risk). Best deals are often made near the bottom of the cycle. Real estate runs in seven to 10-year cycles.

10. This is basic! Ignore cycles at your peril!

Make Money With Different Types of Property Than Houses?

Yes, by all means. Is there anyone in America who has not yet become informed about the massive rises in house prices? New ones, old ones, great ones, junkers, fixer uppers, slum properties? I doubt it.

Some buyers are now shifting their attention away from houses for capital gains (fearing a bubble) and into other types of properties that may not have risen as much.

Scammers and Jammers

People are being pressured to buy remote farmlands, mountainsides, vacant desert lots in non-existent subdivisions, goat farms, rattlesnake and boulder lots without utilities and apartment buildings too far away from job centers to commute. They're also being pressured to buy lots in Latin America where property laws may work to one's disadvantage, remote Canadian wilderness, and other places that are not readily resalable.

I don't even want to mention timeshares!

What Works - Cash Flow and Bulldozers

I've been interested in other types of resalable properties for decades and have bought and sold them. These include rentable houses, duplexes and triplexes, lots with commercial frontage near freeway exits. Not bad. Sure, those old rental houses are eventually going to be bulldozed. But if you can resell the commercial lots they're on eventually for 1,000% or more profit, and meanwhile collect lowball rents, that's just fine.

What About Office Buildings?

1. Yes, I like them, provided you can buy them at 40% or 70% of the appraised value. One negative on offices: they're often suffering 15% to 25% vacancies or more. Many are hard to manage because of elevator and plumbing problems, costly tenant re-dos, and offices are harder to rent and re-rent. But once you do get a good tenant, they may stay for many years. Office buildings are subject to company tenants that look good, but then file bankruptcy, or reduce operations, or try to sublease as firms close out offices, retrenching. Still, you can make some good buys on office buildings in the bottom of the down cycle (when everyone hates office buildings)! You fill them up during good times for cash flow. You suffer buying them 50% to 100% empty, needing work, after the downturn, during the economic down cycle, as well as the real estate down cycle.

Retail Buildings

2. I like small commercial retail buildings, 5,000 to 10,000 sq. ft. sometimes with an apartment above for extra cash flow for owner or tenant to live. These are especially good in outlying suburban areas that are growing. But you may wish to avoid certain retail tenants such as: tattoo parlors, bars nearby, second hand stores and kennels with sick, noisy animals, etc.

3. I like residential property on the blacktop highway, just on the edge of cities with commercial rezoning potential. It's even better if there's an old Victorian house on it that you can rent out to pay taxes, expenses and mortgage, while you wait for the inevitable growth surges to reach you.

As you expand your real estate horizons, you may buy potential commercial edge properties at "residential house prices" just to eventually get the potential commercial land and potential rezoning.

But when buying non-residential properties you must follow the first three rules of 1) location, 2) location, 3) location. You must have that heavily trafficked, noisy commercial frontage that discourages the current owners (so you can buy at steep discount).

You don't want cul de sacs, side streets, nasty neighbors (junkyards, dog kennels, smelly hog farms), anything that would discourage future retail traffic and commerce! Careful here. You really need that "main drag" frontage; 200 feet off to one side is not good. Avoid.

Condomania

4. What about condos? I have nothing against condos, except that in my experience they're extremely hard to resell, even harder to resell during a downturn. And I don't like paying high

monthly association fees that can run not only into $100s per month but $1,000s. Sure, it's great when the association takes care of routine maintenance and landscaping. But you might get assessed for a steep fee for a new roof, new sidewalks, security guards, and the like. The property manager may add in steep fees for themselves for their "services" in hiring other buddies, may even buy themselves an expensive car on your budget or hire coiffed receptionists! Careful.

Property Illiquid Most of the Time

I guess the real reason I don't buy condos, is the liquidity factor. Real estate is illiquid most of the time ... except in the very hottest of markets such as 2005, such markets which seem to come around every 10 years to 30 years after long gaps. Therefore, since I recognize illiquidity of property, good times or bad, I like to do everything I can to improve the ease of resale. Particularly hard to resell can be apartments recently converted to condos, especially in undesirable buildings or poor locations. Careful.

5. What about apartment buildings? I've advised many young people just starting out not to buy a house but instead to buy a duplex, triplex, or fourplex. That way, their tenants help pay off their 15-year fixed rate mortgage. Young subscribers often live in one unit and use monthly cash-flow rentals to pay down the (15-year FRM) mortgage.

As rents rise over years and decades, their monthly rent flow increases, which increases the value of their triplex or fourplex. Then they can resell for a sizeable capital gain or use the excess cash flow to buy more property. Not a bad deal! I've done it.

Larger apartment buildings get into all kinds of problems, such as rent controls, hiring property managers and management companies, evictions, and can become full-time jobs. We have many clients who own large apartment buildings. That's a different ballgame!

SUMMARY: In hot housing markets, sometimes other property markets do not rise proportionately. In particular, small commercial buildings, medical and dental buildings, office buildings, strip malls, vacant commercial lots ... they're all happy hunting grounds, prospecting areas for potential moneymakers.

I prefer to buy within, near, or after bottom of the down cycle, when everyone hates real estate, not when everyone loves it. But first-timers have to start somewhere, and searching in these other areas may be more productive than trying to buy the overpriced house next door or down the block, which has already increased 200% in last five years!

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