

## **Buying Apartments Out of State – Part I**

### **by Tim Elliott**

I know what you'll say. "No, I don't want to sell my apartments. They are doing great! Rents are up, vacancy is down, and I'm making more money than ever! Why would I sell my apartments now?" That's exactly what I said last year. I have owned and managed apartments in Long Beach for 25 years and my cash flow was better than ever. But, last year I sold two buildings in Long Beach and bought in the Midwest. Why?

First, you should know that this idea is nothing new and many property owners are investing out of state. Many brokers in neighboring states like Arizona and Nevada say that 60-80% of their investors are from California, and now even brokers in the midwest say that 50% of their investors are from California.

Many investors refuse to consider investing out of state because they want to be close enough to drive by and check on the property. That is a valid point and I used to think that way. But, do you think professional investors, like managers of like Real Estate Investment Trusts, only buy property near where they live? Of course not. They buy the best property at the best price and find the best management companies to run it. I decided to start thinking and investing like the professionals.

Here are the main reasons I decided to invest out of state:

#### **Return on Equity**

I owned one building for 20 years and had about \$1.2M in equity. But my net income was only \$60,000/year – about a 5% Return on Equity. That is a poor return considering that I did all the management and most of the maintenance. It also seemed quite low considering that savings accounts now pay about 5% and I could be making just as much money each month with my equity in a savings account and with no maintenance or management problems. Since we have had such high appreciation recently, any investor that has owned their property for more than five years probably have similarly low returns. If you are in that category you should take a minute to compute your own Return on Equity (ROE). First, estimate the value of your property and subtract the loan balance to get your equity. Then figure out the annual net income by adding all income sources for 2006 and subtracting all expenses for the year including your loan payment. Finally, divide the net income by the equity to get your Return On Equity. I needed to use my equity more wisely but I couldn't find anything in Southern California that made sense. I started spending many hours late at night searching the national listings on Loopnet ([www.loopnet.com](http://www.loopnet.com)) and PropertyLine ([www.propertyline.com](http://www.propertyline.com)). I found many apartment complexes in the Midwest with 10% ROE that would double my cash flow and get me out of the management business. That was interesting enough to look a bit further.

#### **Appreciation**

We have all enjoyed a significant increase in property values recently but I was concerned that we would have little or no appreciation over the next few years. California has had numerous real estate cycles and it seemed that we were at the beginning of a down cycle. It didn't make sense to own a property with low Return on Equity AND low appreciation. Appreciation in the Midwest is quite low by California standards. Many areas average only one to two percent per year. But, if I used my \$1M in equity as a 20% down payment on a \$5M property, I would only need 1/5 the appreciation rate to get the same dollar amount of appreciation.

#### **Financing**

Here in Long Beach the lenders typically require 35-45% down payment because the prices are so high relative to the income. This is because most lenders require a Debt Coverage Ratio (DCR) of about 1.2. This means the annual Net Operating Income must be 1.2 times higher than the annual debt payments on the property to make sure they have a reasonable chance of getting paid. But sale prices here are so high relative to the expected income that even with 35-45%

down you may still have minimal cash flow. In the Midwest 80% Loan-To-Value (LTV) is common and these properties actually generate 10% returns with only 20% down. So my choice was, put 40% down on a property in California that will generate little or no income and have little or no appreciation for the next few years, or put 20% down on a property in the Midwest that will generate about 10% returns and a low but fairly predictable appreciation.

### **Depreciation**

In California most of the property value is in the land but in the Midwest it's just the opposite. There, most of the value is in the building and the land is less valuable. So at tax time a larger percentage of the investment can be depreciated. For example, my building in Long Beach represented only about 30% of the property value so the depreciated amount was 30% of \$1M or about \$300,000. The building represents about 80% of the value of my Iowa property so my depreciation amount was about \$4M. I make twice as much income and it is all sheltered by the depreciation and expenses. This means I keep more of the income. Also, one of my properties was fully depreciated so I had no more depreciation deduction anyway. Some of you that took accelerated depreciation years ago may be at or near this point. Check with your accountant.

### **Management**

I was tired of dealing with tenants and maintenance issues and wanted more income with less problems. Yes, I could hire a local management company but that would take another 8% off my already meager returns. I was also tired of California laws that favor tenants, evictions that take months, and lawsuits. I wanted a more landlord-friendly state. In Iowa, management is 6% and I can have a tenant physically locked out in two to three weeks. I like that.

### **Diversification**

Many investors own stocks and bonds, stocks for growth (appreciation) and bonds for income. Likewise, it is smart to own some properties for appreciation and some for income. Most financial planners will tell you to put a greater percentage of your investments into income producing investments (like bonds) as you grow older. The same strategy applies to real estate. As you get older it is wise to shift some of your investments to income producing properties to prepare for retirement or medical emergencies. Also, I was 50 years old with a wife and two kids. I had been in the computer industry for 30 years and had financially very successful. But I had been laid off from two jobs in the previous two years and was having trouble finding another job. I had two properties that had appreciated a lot but that appreciation wasn't helping pay my monthly bills. I really needed another source of income. I also wanted to diversify geographically. All my property was in Long Beach and I was nervous that one good earthquake here could cause extensive damage to one or both of my properties, require expensive repairs, and reduce or eliminate my income. So, geographic diversification made sense for me. As Martha Stewart might say, "Diversification, it's a good thing".

I needed to do something but I was very nervous about selling my property here and buying in another state. I was also very nervous about finding a good management company to look after my investment, which is just as important, if not more so, than finding a good property. I finally talked to a former coworker that had done exactly what I was considering. He sold his apartments in Manhattan Beach and bought 300 units in Corpus Christi, Texas. **He tripled his income and found a very professional and honest management company to relieve him of day-to-day responsibilities.** He is now enjoying his retirement much more than before and has extra income to help pay for his daughter's college expenses. His experience was enough to bolster my confidence and make the decision to invest out of state. So I sold my 12 unit building in Long Beach and bought 144 units in Cedar Rapids, Iowa. I doubled my income and have on-site management and maintenance to take care of all the day-to-day issues. They send me monthly reports and I review daily banking activity on the internet. I also set up an ACH account to transfer money electronically to many different accounts. I also sold an eight unit building and bought 100 units in Kansas City, MO. We had to clean house there but are now on track to double my income this year. *Next month – Part II.*

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