

Best Practices for Landlords – Part I

by Vena Jones-Cox

While there is no commonly accepted definition of the term “best practice”, it can be loosely defined as “a technique or methodology that, through experience or research, has proven to reliably lead to a desired result.” Many business and professions develop “best practices” as overall systems under which the general operations of the enterprise should be run. When committing to best practices, these companies encourage their officers and employees at every level to use all the knowledge and technology at their disposal to ensure “success”, as each company defines it.

Best practices are not the same as ethics or a code of conduct. These things generally address how one achieves success in one small area without regard to whether the business or individual that follows them is profitable.

Best practices are not the same as strategies, which normally address the specifics of making money without regard to whether it is being done in an ethical manner.

Best practices are not a study in how to run a business according to the law, although they may address legal issues where necessary. Nor are they a set of guidelines that address every possible scenario or challenge that a business might face. Instead, best practices are general guidelines that time and experience have shown to be the most likely route to some subjectively defined success. Reaching that goal usually requires a combination of strategy, ethics, AND following the applicable laws and regulations for the business.

Real estate investors, unfortunately, do not have a generally accepted “best practices” system. Although there is information galore available regarding every possible technique, the information is: 1) often contradictory and 2) almost entirely oriented toward “strategy”, not ethics or possible legal issues.

In fact, most real estate investors are guided by two things in the operation of their businesses: their own experience (which is only achieved through trial and error, and is generally an expensive and lengthy thing to obtain), and/or the experiences of others—colleagues and “gurus”—who may or may not be operating successfully or in the ways in which they report that they are acting.

Real estate investing presents certain problems in regards to defining and achieving best practices. The primary problem is that real estate investors tend to be in different financial situations, have different goals and resources, and live in different markets with different local economies and laws. Thus, the goal of “a good deal” might be achieved very differently by a wholesaler in Akron, Ohio versus a wholesaler in Los Angeles, California.

Secondly, real estate investing is a very people-oriented business, involving buyers, sellers, renters, contractors, private lenders, and endless other individuals, most of whom have no “best practices” for themselves, and who will not necessarily operate according to the investor’s best practices. And finally, real estate investors have no affiliation with a professional association that does research, collects data, and suggests or requires best practices of its members.

So, we in the real estate investment industry have been left to do the best we can, absorbing whatever education we have access to, processing and refining it for use in our own specialties, defining our own personal codes of ethics, and cringing inwardly when we hear about a colleague who has operated in an illegal or immoral manner, or who has catastrophically failed in business, leaving a trail of bad debts, bad P.R., and damaged individuals in his wake.

What I Hope Will Happen

Despite the challenges, I believe that it is possible to lay out certain universal best practices for

various aspects of real estate investing. What's more, I believe that it's necessary for such a thing to be done, and to be accepted as a guideline for the operation of a successful, profitable, and ethical real estate investing business. Possible, because successful investors should be able to agree that certain philosophies and activities invariably lead to a good outcome for all involved while others don't; necessary because recent legislation aimed at "regulating" the bad actors in our business has shown that when politicians develop our "best practices" for us, they will be so restrictive that even the good guys can't operate.

I am not laboring under the delusion that every real estate investor will believe, accept, or operate under any best practices procedures that are presented to them. Nor am I under the impression that I have the right or ability to enforce them—or even that I'm qualified to develop them on my own.

My goal is to sketch out some procedures that, according to my experience and that of others whom I respect and believe to be successful in the truest sense of the word, lead to the best possible outcome. It is not to teach specific strategies or techniques—that's still best left to specialists in each category—but to create a set of guidelines by which those specific strategies can be measured. It is to define "success" in a way that goes beyond profit, and to outline the general practices that are most likely to achieve that outcome.

From Best Practices to Best Outcome

Since best practices are not a random set of rules to follow, but rather a path to a desired outcome, the first hurdle to overcome is to define what the "successful outcome" looks like. In general, best real estate practices will lead to these outcomes:

1. Good, safe, healthy living experiences for tenants/residents/buyers—in other words, good customer service.
2. A good experience for neighbors, neighborhoods, the community at large—in other words, good corporate citizenship.
3. Full understanding by buyers/sellers/tenants of all rights, responsibilities, likely outcomes, and consequences of a particular deal—in other words, full disclosure.
4. Full debt payment to lenders and/or sellers who finance properties
5. A profit for the investor—in other words, that he reaches his financial goals

Best Practices for Rental Property Owners

Argument: Rental property owners, as a group, have perhaps the poorest reputation of all real estate investors. They are often viewed by neighbors and local officials as a "scourge" on the neighborhood, both neglecting the appearance of their properties and bringing in a "bad element" via tenants. They are regularly "regulated against" in an attempt to curb or control their activities. My belief is that most rental property owners start their careers intending to be good landlords and good neighbors, but fail due to a combination of carelessness, lack of education and skills, and lack of financial wherewithal to properly maintain their investments. These best practices are meant to achieve the following outcomes:

- A positive living experience for the resident/customer
- A positive experience for neighbors, be they tenants or fellow property owners
- Financial success for the investor

Best Practices: Purchasing

Many rental property investments are doomed to failure before the property is even purchased. If the investor buys the property in such a way as to insure that it will NOT reach his financial goals, or if he is ignorant as to the real costs and challenges of owning a rental property, human nature dictates that he will become frustrated with and ultimately give up on the property. Therefore,

prior to purchasing a property, the investor following best practices should:

1. Set financial goals for the property, both long and short term. Without actual numerical goals for cash flow, appreciation, and so on, it's easy to become enamored of a property that is in great condition, is reminiscent of a childhood home, and so on. This scenario almost always leads to overpaying for a property, which leads to negative cash flow and other financial problems, which leads to struggles with maintaining the property and servicing the debt. The best practice is to decide in advance what the financial goals are, then find and purchase the property that meets them.

2. Become educated as to the business of managing and maintaining rental property. This includes training in local tenant-landlord law, fair housing law, eviction procedures, lead paint disclosure and safe maintenance practices, tenant screening, bookkeeping, and general skills in managing residents. Again, this should be done prior to the purchase of the first rental property, and is crucial to a successful landlording experience.

3. Join a real estate investor's or landlord's association for ongoing support and education. These associations keep their members abreast of changing regulations, give them a voice in local politics and, most importantly, provide networking with other rental property owners and the vendors who serve them.

4. Evaluate the property thoroughly. This includes a complete inspection of the property to determine the condition and the need for immediate and medium-term repairs, as well as a financial evaluation of the probable income and expenses. Many rental property buyers are not prepared for expenses in vacancy loss, replacement reserves, turnover costs, accounting costs, and so on. These expenses generally range from 20%-40%+ of gross rental income, depending on the property type and area. New investors almost always underestimate the expenses other than principal, interest, taxes and insurance, which can easily lead to unwanted negative cash flow and the associated problems with maintenance and debt service.

5. Insure that he has the financial wherewithal to maintain the property. Having access to cash and/or credit to take care of immediate and unforeseen short-term repairs is crucial; having the financial discipline to set aside cash flow for replacement reserves also assures that the property will not descend into the "slumlord cycle" of poor maintenance leading to less qualified residents leading to less income leading to poorer maintenance etc.

It is generally NOT a good practice to buy properties with negative cash flow. In some cases, the investor may choose to purchase a property with negative cash flow in order to capture a large chunk of equity, or to purchase a property with high appreciation potential, or to accelerate mortgage pay down. If the investor has chosen this, and is at the same time financially capable of maintaining the property through the period of negative cash flow, the strategy is certainly not prohibited; however, for most people at most times, positive cash flow assures their continued interest in—and ability to maintain and pay for—the property.

It is generally NOT a good practice to finance the property for more than 80% of value. Although loans of 90% or more of appraised value of a rental property are somewhat common, securing such a loan is usually a bad idea for several reasons. Not only do these loans usually carry higher closing costs and interest rates (which negatively affect cash flow) and, of course, carry higher payments due simply to the higher loan balance, but they also make it difficult to sell the property without a real loss. In a worst case scenario where the investor discovers that he has made a poor choice of properties, or doesn't care to be a landlord, or has personal issues that require him to sell quickly, sales costs generally exceed 10% of the total sale price. Add holding costs, seller concessions, and a quick sale can net as little as 82%-85% of the actual sale price. This is not to say that a rental property cannot be financed for 100% (or more) of purchase price, if the purchase price is less than 80% of the value. However, another thing to take into

consideration is the fact that most non-owner-occupied loans carry an adjustable rate of interest, so the decision about whether to pull cash out of a purchase or refinance must be based, in part, on the multi-year outlook for interest rates.

Best Practices: Applicant Screening

In line with the overall best outcome of a rental property ownership experience, the goals of applicant screening are as follows:

1. To rent to tenants who will pay as agreed, honor all terms of the lease, and maintain the property in good condition excepting ordinary wear and tear. This, in combination with other best practices, insures that the outcome will be profitable and that the rental property owner will be able to maintain and pay any debts against the property on time and in full.

2. To rent to tenants who will not be a problem to neighbors or the neighborhood.

With these outcomes in mind, the investor following best practices should:

A. Get a full application. Rental applications are available online or from many real estate investor associations. A full and complete application will include:

- Names and social security numbers of all potential occupants over the age of 18 and total number of occupants who will live in the property
- Address and owner of current residence and previous residence.
- Current rent or house payment, current utilities and other expenses associated with the residence
- Source of income for all applicants over the age of 18, including place of work, position, salary, length of employment (same information for last position if length of employment is less than 1 year) and supervisor name and phone number.
- If applicant is unemployed, source of rent and contact information for that source
- A signature line for all applicants granting permission for the property owner to run a credit check and for previous landlords and employers to provide information necessary to process the application

B. Check the application fully. Perhaps it is needless to say that applicants can and do misreport every detail from their name and social security number to their current and past residences. Because the applicants who are willing to go furthest in making up documentation are also the applicants who are most likely to be destructive, non-paying tenants, it is incumbent on the property owner to use a combination of public records, credit records, and legwork to ensure that the applicant is in fact who he purports to be.

- Check a photo ID of all applicants over the age of 18, matching the social security number with the one reported on the application
- Check the credit report of the applicant(s) for reported addresses and times of occupancy that do not match with the addresses filled in on the application. If there are addresses on the credit report that do not match those on the application, investigate until an explanation is discovered. In most cases, the applicant will not report an address from which he has been evicted.
- In the local tax roles, check that the owner of the current residence reported on the application (or on the credit report, if it's different) is in fact the owner of record. If the owner's names do not match, try to contact the owner of record to resolve the issue; if this is not possible, call the reported owner and ask for an explanation of the discrepancy. Applicants very often report the correct address of their current home, but give the name of a friend or family member as the owner or manager to avoid a poor prior landlord report. This can be uncovered by asking the reported owner/manager questions like, "is the rent \$995?" when the tenant

has reported it as \$695, or “they say they’ve lived there for 5 years, is that right?” when the tenant has reported living in the property for 9 months.

- Check the criminal records in the area(s) where the applicant has lived for the last five years (or use a service that does this) for the applicant’s criminal history
- Check the civil records in the area(s) where the applicant has lived (or use a service that does this) looking for suits by and against the applicant
- Check the sex offender registration rolls (where applicable).

C. Check the applicant’s current residence for condition, where possible. This requires a home visit.

D. Set minimum standards for your rental property. Some items in an applicant’s history or situation predict almost certain failure of your desired outcome. These include:

- Applicant’s proposed rent is more than 15% more than current rent
- Applicant has been evicted for non-payment or lease violation in the last two years
- Members of the household have drug-dealing convictions in the last five years
- Members of the household have violent or sex-related felonies in the last five years
- Applicant earns less than three times the monthly rent
- Home visit shows interior of current residence in poor condition beyond ordinary wear and tear
- Home visit shows pets, if you have a no-pet policy
- Applicant is a habitual filer of lawsuits

E. Run the information gathered against a minimum criteria checklist that you have developed for your company. This checklist should reflect your experience (or that of others) in regard to what makes a tenant “successful” in the sense that he will be capable of paying rent on time and in full, maintain the unit in decent condition, and be a good neighbor. These checklists are often graded using a “point” system, where a successful applicant achieves a certain minimum score in order to be accepted. Criteria might include:

- Length of time at current residence
- Length of employment
- Credit score
- Current vs. proposed rent
- Current and past landlord recommendation
- Possession of a checking account
- Savings

F. Follow all applicable federal, state, and local fair housing guidelines in processing the application. Document each step of the process, including why the applicant was accepted or rejected, and keep documents on file for at least 5 years.

Next month: Best practices in maintenance and management. More information on lead-safe practices is available at www.EPA.gov. Reprinted from The Real Deal Newsletter with permission of Vena Jones-Cox. Subscription costs \$120 per year. Get a free 3-month trial subscription at TheRealEstateGoddess.com.