How Cheap is Cheap Real Estate?
Yardsticks to Measure Profit
By John V. Kamin

When you buy distressed properties, adding liquidity to illiquid situations to make transactions work, risking your cash and your credit, you hope to make a profit for taking those risks. But exactly how much and when do you make your profit?

The book <u>How to Make Money Fast Speculating in Distressed Property</u> suggests that you must engineer the transaction and plan it so that you can make a profit by reselling in the current (depressed) market. Sure, it's good if you can afford to hold five to 10 years or longer.

But it would be a blunder to buy at full ticket current market, based on what houses might bring in 2016 or 2022. You're looking for deals below the current 2009 market.

Here are more valuable parameters. During the late 1980s to early 1990s downturn, the Resolution Trust Corporation was set up to get rid of a glut of foreclosed properties that overloaded S & L's and banks. The FSLIC had so many bad loans and payouts that it had to be folded into the FDIC an FSLIC disappeared.

The RTC was set up by CPA William Siedman to sell and auction of these REOs (Real Estate Owned by banks and lenders). How much money did the RTC get when it auctioned those properties?

After the dust settled, it turned out that the RTC realized average 59% of low appraisals on buildings including homes. Auctioning and selling vacant land, the RTC realized 41% of low appraised values. That is what properties sold for. Do you think that's high or low?

Our clients who bought properties from the RTC did very well during the remainder o the 1900s decade and beyond, well into the 21st Century boom in real estate.

More Keys to Profit
Stick to modern properties. You don't want 90 year-old termite-ridden wrecks, teetering, bowed in the middle, where the doors don't close, the foundations sag and the windows are ready to pop. You want modern buildings up to code.

You also want locations near the major job centers within commuting distance of jobs. Something that is cheap because it's remote, not within commuting distance of major metro job centers will stay cheap. Avoid these. This is common sense.

Useful Yardsticks
Here are some yardsticks I use when making offers based on current market. You're going to have real estate expenses, whether you sell in this market or some future years. Therefore, when you are the reseller, expect to pay a broker's fee of 6% to 10%. You'll

also have to pay for Title Insurance; you'll pay 50% or more of escrow expenses. Right out of the gate, you'd better figure about 10% below the current 2009 frozen market appraisal just for resale expenses.

You will also have repair expenses, depending upon the condition of the building. Expensive items are new roofs, new heating, new air conditioning, foundation repair, plumbing and electrical wiring. Also expensive are when homes or buildings have been trashed with stolen appliances, kicked-in walls, graffiti and smashed windows.

I've never purchased a building where I didn't have at least some roof repairs or needed a new roof. Usually, if the building has gone into foreclosure or has been vacant, new heating and air conditioning units may be needed along with new plumbing. Former occupants often vandalize and wreck buildings as do squatters and thieves.

Profit-Peak Vital

Therefore, before you estimate 5% or 10% or more for necessary repairs before resale and occupancy, you must do an inspection of the premises. Maybe it looks OK on the outside but from the inside, or on the roof, it may be a house of horrors. **Don't cut corners on inspections.** You can't afford to buy sight unseen as some real estate advisors are suggesting; those who try to sell Californians cheaper houses in Texas, Louisiana and Florida, un-inspected by you, the buyer. **Don't buy blind.**

Suppose you can't get inside to inspect. Then your repairs discount from appraised value should err on the high side, not the low side.

Since you wish to make a profit for risking your cash and your credit and your carrying costs until date of resale, when you actually resell for a profit, you should probably look for a 20% profit, more or less, based upon your final 2009 purchase price. If you can't make 20%, why bother? There are other competitive fields out there where you can earn substantial money (10% to 18% on Tax Lien Certificates), without going through all the hassle of actually owning distressed property.

Therefore, if you're buying a vacant property for $200,000 after all deductions for repairs and resale expenses, you should be hoping to resell it at least 20% higher than the total you paid, over and above your cost of ownership.

How Long Until Money Flows to You?

You'll have to estimate your holding period until you can resell it. During that time, you'll be responsible for paying property taxes, insurance plus interest on any mortgage that you can arrange. If you estimate your holding period at 36 months, you'll have three years of property taxes, insurance and interest. If you don't cover these costs, how can you resell at a profit? Properties do take much longer to resell in this depressed market than in a boom market where buyers are lined up; something that happens only 10% to 20% of the time!

Forced Sales
During the 1990s, the market in Japan, as well as in the U.S., turned soggy. Japanese banks and execs had been buying trophy properties in the U.S. during the late 1980s just to own them: famous buildings and famous golf courses, etc. But when the recession hit, many of the lenders in Japan not only had to sell trophy properties at steep discounts, one the ones they couldn't sell, they carried them as bad loans for up to 15 years pretending they were good loans. This delayed recovery from the recession in Japan by many years!

You don't want to be placed in that position. For example, if you plan on buying a property for a profit and then reselling you may mis-estimate the necessary holding period by several years. Instead of three years, maybe it will take 5 or 7 years to resell.

In this particular area, after the January 17, 1994 earthquake, properties in the Northridge earthquake zone could not be resold for up to seven years. That's how long it took new buyers to "forget." (Even though many of those properties had been completely remodeled, refurbished and redesigned with big bucks spent so that they look like new!)

Therefore, you want to estimate your potential holding period to be as accurate as possible.

What's Cheap, What Isn't?
According to my experience, here is what is not acceptable at a cheap price: bad locations, zoning problems, remote properties or boondocks, obvious disadvantages such as bad neighbors (junkyards, tanneries, landfills, crazies, etc). Avoid these. You're prospecting for profits and NTS (need-to-sell) properties because they have to be sold for other reasons such as to raise cash, settle estates, settle mergers and court orders, asset liquidations by bankrupts companies and creditors, divorces, lawsuits and government orders.

I avoid certain communities in northern Ohio that are trying to shrink. Avoid communities that have so many vacant homes that it affects resale of the occupied homes and tends to reduce resale prices.

Just because something is cheap because it's priced below replacement cost doesn't mean it is well-designed. In a costly energy-environment, you don't want buildings that have very high ceilings, leftover pollution from gas stations and chemicals and chromium or lead discharges. You don't want the government coming in and making you part of a superfund clean-up site before you can resell the property! You're looking for properties that must be resold for other reasons, usually financial but often other kinds of liquidations.

Cut Your Standards?
I get all kinds of calls in here where people want me to approve or "bless" their transactions on properties that are badly located. Hopefuls may come to me with a bargain half-vacant office building that is off the visible main drag, the arterial highway, located a couple of blocks away where it is nearly invisible to potential buyers and

tenants. Or someone may call me about a near-foreclosure remote desert property, too far from the major job centers to commute. Those are cheap for very good reasons. I predict they will stay cheap.

For example, on multiple properties, sometimes buyers will try to cherry pick the best one out of three that is on a corner, so that if you sell that one lot to the buyer, you're stuck with the two non-adjacent lots nearby that aren't on a corner and might have inferior zoning position in the immediate future. Tip O'Neill, former Speaker of the US Senate used to say, "All politics are local." I would paraphrase his saying to "All real estate is local." Think location, location, location and not at platitudes and generalities such as saying "South Florida will grow when the recession is over" to justify an imprudent current purchase. Don't lower tested proven standards – lower harder.

How to Buy Cheaper Than Cheap
Valuable Tip: On properties that are nearing foreclosure (and therefore listed cheap); I sometimes have to tell clients "Wait up! Let the property be foreclosed. Then, after the lender bids the price of the mortgage, you can go to the acquiring lender a little later and offer him 20% below what he paid at the mortgage foreclosure auction as an REO." Got it?

How to Get Sellers to "Eat Paper"
Furthermore I often have to tell my clients to quit scrambling for a mortgage. If you're going to buy an REO from a lender who foreclosed, ask the lender to finance 80% to 90% of the purchase (even though you can afford a large down payment or all cash.)
Tell the foreclosing REO owner that he ought to lend to you because:

a) you'll pay property taxes and insurance instead of him
b) he'll get immediate cash from your 20% down payment or so
c) he'll be earning interest instead of paying interest on borrowed money
d) you plan to improve that property, sink money into it (that he won't) to bring it up to modern resalable standards, lessening his REO risk for the loan

After all, if he loaned a lot of money on that same property in the past, much more, he ought to be willing to lend you 80% or so of the current reduced price and loan amount. Wouldn't it be better for the lender-forecloser to have money and interest coming in and you paying the expenses rather than having the lender paying all that?

In a nutshell, this is how you sell "seller financing" to a former lender with a vacant REO!

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