



BUYING RIGHT – HOW TO ANALYZE CASH FLOW, VALUE, AND LONG TERM PROFIT BEFORE YOU BUY

Buying Right is a cornerstone in the foundation of successful investors. Many factors are involved in “buying right”. Buying right is not limited to purchase price only. Many folks assume “buying right” means stealing a property with price alone. Experienced investors consider price just one part of buying right.

Factors to buy right include how to analyze:

- CASH FLOW
- VALUE
- LONG TERM PROFIT

CASH FLOW is an absolute must for investors getting started from ground zero. Without it, you won’t survive. You’ll go belly up. It’s frustrating to hear all of the definitions of cash flow in the market today. Many real estate agents will talk about “positive cash flow” based on super inflated monthly rent minus the mortgage payment. If only this were true.

Here is the **real world monthly cash flow**:

- Actual Rent minus
- mortgage payment
 - property taxes
 - homeowners assn or condo fees
 - insurance
 - repairs & maintenance
 - vacancy (3%)
- = REAL CASH FLOW

Believe it or not, there are many properties you can “buy right” as far as price, but bottoms out in cash flow. It’d be a bucket with a big hole in it. This usually happens on higher priced houses.

For example, in my town, a \$80,000 house should rent for close to \$800; however, a 150k house may rent \$900 to \$1200. Even worse, a 350k house may rent for \$1500. Talk about horrible cash flow. Although prices and monthly rents are different across the country,

I bet the same rule applies in your town when it comes to single family homes. Start adding duplexes, multi-family units, apartment communities, or commercial property and cash flow results will vary greatly.

Therefore, there’s no universal “percentage” formula. You must do the math **BEFORE** you make an offer. On single family homes, you must know market rents. This can be learned quickly by reading the classified ads or making a few phone calls from yard signs in your neighborhood.

After learning market rents, determine **real world cash flow**. I change things up a bit to benefit me. I pay Mike **FIRST** when ciphering. Get used to putting yourself first. Many folks have a tendency to get emotionally involved to help sellers. Unless you have a job with a government agency specializing in helping folks, you’re not a welfare agency. Etch this in stone....

IF you go belly up, NOBODY will bail you out for FREE. It just won’t happen. Pay close attention to your numbers before making your offer. For this reason, put yourself first. You have all the risk and should be buying right to benefit you. I’m not against helping sellers, I’m against hurting me. WIN-WIN is best for both..

Here is my formula for real world cash flow:

- Conservative Real Market Rent minus:
 - Mike’s minimum positive cash flow
 - Property taxes
 - Homeowners Assn or Condo Fees
 - Insurance
 - Repairs / Maintenance
 - Vacancy factor (3%)
- = Maximum Allowable Loan Payment.

Let's apply it in a sample situation:

Market Rent: \$850

Mike's Cash Flow: - \$200 (*pay me 1st*)

Property Taxes - \$ 50

Homeowners Assn - \$ 0

Insurance: - \$ 25

Repairs: - \$ 50

Vacancy: - \$ 25

Maximum Allowable

Monthly Debt Service: \$500

The above example is designed to give Mike \$200 per month positive cash flow providing the monthly debt service does not exceed \$500. Knowing these numbers before making your offer, puts you in a position to make a good, safe offer with a margin for good cash flow.

Use this formula in reverse to cipher a sale price and compare it to market value and the sale price. Ask yourself how much money can I buy for \$500?

At 6% = \$83,395

7% = \$75,153

8% = \$68,141

11% = \$52,500

15% = \$39,543

All dollar amounts borrowed have a monthly payment of \$500 for principal and interest on a 30 year loan.

Assuming you want to buy with no cash out of pocket financing 100% of your purchase price, you'll quickly see how much you can borrow.... ciphering your purchase price at the same time. If you have access to cheap money, 6% or lower, good news for you! Even with a hard money lender at 15% you'll know your limit in determining a maximum allowable purchase price.

Suppose your seller is asking \$75,000 for the property and you have access to 6% money. You could actually offer full price and still have good cash flow. In the real world, we might get a little bit greedy and try to knock down the price a bit more.

If your only resource to cash is 15% money, you can't touch a sale price of \$75,000. The most you could borrow on this property to give you \$200 month positive cash flow would be \$39,000. Therefore to finance it 100%, your offer would have to be \$39,000 or less using 15% money.

The opposite extreme would be a cash resource with 0% interest. Impossible? Absolutely not. I've done several deals with ZERO interest, but it does require a very motivated seller. With 0% interest, you could finance 100% of a 180k purchase and have payments of \$500 for 360 months. This would still give you a \$200 per month real cash flow.

I'm not trying to make cash flow confusing or complicated. Assuming investors strive to acquire good property with no cash out of pocket while capturing a decent cash flow, the challenge is understanding how to accurately measure the cash flow of an investment with maximizing the resources available to you.

VALUE

Many definitions exist for this word in our arena of investing in single family homes. Education-wise, I grew up in an aggressive, high risk, take action now investor society where we were brain-washed into believing we made our money when we buy right. Although mostly true, I vividly recall Chris Dischinger's story told by his mentor Don Kestler. "It's easy getting in a deal, getting out is sometimes the hard part."

What does this mean? Ask any experienced, seasoned, long term "successful" investor and you'll have another mini-seminar. The short version in a nutshell is motivated sellers can be found with all kinds of properties – the good, the bad, and the ugly. A lot of them have the bad and ugly properties. Successful investors have the ability to "cherry pick" motivated sellers with good properties. They've learned to identify the good ones quickly.

Successful Investors KNOW VALUE

What is it? Where is it? What does it look like? These questions are asked all the time. Capturing a good deal is the ability to buy at or below market value and/or with terms to dramatically enhance the value of the investment

You can't steal in slow motion. Paralysis of analysis might be the cause of you missing a deal to a competitor. But, that's okay. I would rather miss 10 good deals than get 1 bad deal.

Remember the frequently used phrase "houses always go up in value"? Not always true. How about trailers and mobile homes? Some folks call these houses. They are like cars and actually go down in value with age. Yes, they can be "cash cows" in the cash flow department; but it would be a hard sell to convince an investor they go up in value compared to a house without wheels.

Real house value factors include market conditions, trends, and your local economy. Right now, in our town we have too many houses and not enough tenants. The local apartment communities have outrageous vacancy rates. Today they have 20%+ vacancy and a couple have 40%. Their target vacancy rate in their business plan is 5%.

We have a "HOMES" magazine where agents advertise properties for sale. These books can be had for FREE in supermarkets and food marts. Without picking the magazine up, you can tell what's going on in the market by simply noting the thickness of the publication. Ours used to be 1/4" to 3/8" thick. This means almost anything put on the market is selling. This is known as a seller's market. Right now this same booklet is almost 1" thick and looks like a phone book. It's been this way for over a year. This means properties are sitting on the market for some time resulting in a buyer's market.

Foreclosures are at an all time high and another factor. Recent easy access to home loans and the "cash out your equity rush" with a 125% ltv loan are catching up with borrowers and uneducated investors.

Knowing Value is knowing your market and what's happening now in your market.

Quality is confused many times with value. Don't confuse quality for value. Junky, stinky, poorly built, war zone neighborhood, all affect the value of a property, but this is a result of the quality of the property. Take a good sound solid house in a good area and change one thing... Location... move the same house into a war zone and see what happens to value. It'll go down the tubes in value.

Let's use a "quality" scenario on vehicles. A two year old, in good shape, Ford F-150 pick up truck might have a blue book value of \$18,000. One might say if you could buy it for less than \$10,000 you'd captured a great deal because the value is \$18,000. How bout a 15 year old Ford pick up, smoking and a knocking motor, with a blue book value of \$900.00. Would \$500 be a good deal? They both are trucks, but the quality affects value.

Stay current with your market values. Read the Sunday paper for real estate transfers and property for sale. Good investors keep their finger on the pulse of their own market.

LONG TERM PROFIT

First of all, what is long term profit? Some may think 10, 15, or 30 years is long term. How about following the IRS's guideline. If you want to try to do a 1031 tax deferred exchange immediately after buying a property, we've been told in order to qualify safely, the property should've been acquired with the intent to be a long term investment. This opens the door for less than 12 month of ownership and still complete an exchange. This is an exception to the rule, But many agree as long as the property appeared on two consecutive tax returns, it should qualify as a long term investment.

Using this guideline, let's define "long term profit" as two years or more.

Long Term Profit is what investing is all about. I cringe when folks call themselves "investors" when their program is buy, fix up, and sell. Where is the investing? "Investing" means long term. When they sell, it's over. It's no different than selling widgets, buying wholesale and selling retail. Don't get me wrong, it's ok to buy and sell to "feed the machine", but the buy and sell program is not investing.

Nobody has a crystal ball to accurately predict the future. We can only educate ourselves and minimize our risks associated with investing.

Variables affecting long term profit include:

- Quality and Style of property
- Location
- Tax concerns, strategies, depreciation.
- Property Management Program
- Financing & Cash Flow
- Appreciation
- Local & national economic factors

For long term profit, quality and style of the property plays an important role because it will directly affect your cash flow. Get a junky, old, leaning, frame house and although you may have phenomenal cash flow, this one will be a management intensive, poor quality property. I like to say "Quality of the Tenant parallels quality of the property." Bad tenants can get into a high quality property, but seldom do high quality tenants pursue a poor quality property.

Style of property. What is the most popular style of house in the market today? Very few one bedroom houses are being built. Years ago after WWII, baby boomers entered homeownership of 2 and 3 bedroom homes in the suburbs. Most of those were no more than 1,000 square feet. Today, the "cookie cutter" new housing floor plans usually have 3-4 bedrooms, 2 baths, and are no less than 1300 square feet. Now these are the small first time homebuyer houses. Style also includes the floor plan of the house. Shotgun, one story ranch, 2 story, or jack-legged goofy built houses all affect style.

In order to stay in the groove for the long term, you can see to target 3-4 bedroom, 2 bath houses with good floor plans for long term profit.

While on this subject, investors know of the risks of the pre-1978 built houses involving lead based paint. Today, houses built in 1978 are already 25 years old. Odds are, with time, the environmental regulations involving housing will only get worse and more restrictive. It's almost like a new hazard is created each decade. Asbestos, lead, mold, and mildew have been in the forefront. Newer housing, constructed properly, should have less risk in the long term.

Location, location, location speaks for itself. Make sure your properties are in good areas. This will affect appreciation, cash flow, and quality of tenants, and the sale-ability of the property.

Tax concerns and strategies greatly affect long term profit. Some investors have other income to buy groceries and are tickled pink to have properties simply break even in the cash flow department. These investors have a field day with income tax savings from depreciation. For example, a \$250,000 house on a \$50,000 lot will allow the investor to depreciate \$200,000 over 27.5 years. This is equivalent to lowering your taxable income by \$7,272.72 each year for the next 27.5 years. Although \$7,200 might not get you excited, if this same investor had 10 houses like this, the investor would own 2.5 million in real estate and would have over \$72,000 in depreciation EVERY YEAR. Imagine lowering your taxable income by \$72,000. This is a no-brainer in reducing income tax now.

There's no free lunch. There are deferred consequences with depreciation. Without the proper knowledge, you could get spanked when you sell the property. The same property above, if sold after 10 years, would have reduced the cost basis by 72k. The IRS says the house you paid 250k for 10 years ago has been adjusted to 178k because of depreciation. If the property doubled in value in 10 years to 500k, you have a \$322,000 capital gain. This would be a good candidate for an exchange to defer the tax.

Property Management is a major factor in long term profit. Are you doing it? Will you hire a property management company? A good efficient tight ship operation is desired. A poor system will get poor results killing your long term profit. In fact, poor management can kill the value of a property. Imagine putting a trash bag tenant into a quality property. This happens frequently when not doing your homework on the front end screening a tenant properly. Your once wonderful house could quickly become the eyesore of the neighborhood and worse.

Financing and Cash flow mentioned earlier are factors involving long term profit.

The appreciation game opens another can of worms among investors. Some advise against it while promoting cash flow only, and some encourage it as the only game in town. Appreciation is different all over the country. On the west coast and in Florida, properties in good areas are appreciating at 20%+ ANNUALLY! Outrageous, but I doubt it will last forever. Back home, here in Louisville, we don't have 20%, but over the last 10 years we've probably averaged somewhere in the 5-7% range. Investors in Dayton, Ohio tell me their annual appreciation range MIGHT be 3% on a good year.

Knowing this now, and with all of these extremes, for long term profit, a good rule of thumb is good real estate in good locations usually go up in value.

Those areas with the 20%+ appreciation will be hardest hit when economic factors change. Those with the largest peaks in appreciation usually have the deepest valleys when their market rebounds. Just recall not too long ago, the west coast market bottomed out and folks owed more on their property than what it was worth. Back here, although we don't have the super high peaks of some booming markets, our valleys are pretty shallow and safer to survive.

Also, keep in mind the local and national economic factors. Just a few years ago, prime was at 9.5% and things were pretty good locally. Since interest rates dropped to an all time low and stayed there for some time, it has affected our investments. This allowed borrowers to "buy more house" causing prices to appreciate a bit faster than normal. It also set the stage for our long term tenants to become homebuyers. I experienced this myself with my little brother Denny. Long story short, he was able to buy a house I would normally rent for \$800-\$850 a month and his total piti payment was only \$543.00 on a fixed rate 30yr loan

Imagine what mortgage brokers and real estate agents are telling tenants. "Why are you paying \$850 rent when I can put you in a bigger or new home for only \$550 month?"

According to the media and financial gurus, it looks like the low interest days are coming to an end. There is talk of the feds raising rates. Here is what will happen. When interest rates rise, borrowers get to buy less house = stagnant appreciation. It will be a bump or hiccup for a short time. Rents will be allowed to catch back up with mortgage payments and hopefully mortgage payments will be higher than rent. When this happens again, there will be plenty of tenants and not enough houses.

For the long term profit, real estate always goes through cycles that can usually be matched up to similar conditions in the past. Those who stay on top of trends reduce their risks getting more bang for their buck.

Before you make your next offer, make sure you buy right and properly cipher cash flow, value, and long term profit.

Keep Cranking It 24-7,

Mike Butler