The Ultimate Residential Income Property Success Guide

REAL ESTATE

The Ritchey Team

Residential Income Property Specialists

CA DRE Lic. No's: 00604585 & 02140218

BakersfieldIncomeProperties.com

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"Ninety percent of all millionaires become so through owning real estate. More money has been made in real estate than in all industrial investment combined." – Andrew Carnegie, industrialist, businessman, entrepreneur and a major philanthropist

"Every person who invests in well-selected real estate in a growing section of a prosperous community adopts the surest and safest method of becoming independent, for real estate isthe basis of wealth." – Theodore Roosevelt, 26th President of the United States

If I were to ask you what the three most important words pertaining to real estate are, what would you answer?

If you are like 95% of the population, you would answer, "Location, Location, and Location." Things have changed. I believe the new answer should be "Timing, Timing, Timing." If you are an investor the answer should become "Knowledge, Knowledge, Knowledge."

In this book, I am going to teach you how to determine if it is a good time to buy or a time to stay out of the market. You will learn how to make this decision based on facts. Here are some other things you will learn in this book.

- **You will learn how to become a professional investor, not an amateur speculator.**
- **You will know how to analyze properties to determine what yield you will receive and how to maximize that yield.**
- **You will learn how to get a great yield without appreciation.**
- **You will learn how to save money on your taxes.**
- **You will learn how to purchase property with low down payment.**
- **You will learn the power of leverage.**
- **You will learn the four ways money is made investing in real estate and which one is the most important.**
- **You will learn how to Win the Game of Money by Building a Real Estate Money Machine.**

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ABOUT BOB RITCHEY
FOUNDER, THE WIN THE GAME OF MONEY INSTITUTE

Bob Ritchey, a California native, received a Bachelor of Science degree in 1964 with a major in mathematics and a Master of Education degree in 1965 from Miami University in Oxford, Ohio. He moved to Bakersfield, California, in 1965 to teach mathematics at West High School.

Bob started investing in real estate in 1976 and obtained his real estate license in 1977. In 1980, he received his real estate broker's license. He has been an independent real estate broker for 30 years.

During his real estate sales career, **Bob has sold over 1000 investment properties with a sales volume of over $100 million dollars.**

TGR Realty – Income Property Specialists was founded by Bob in 1992. The company was named for the book, "Think and Grow Rich" by Napoleon Hill.

The goal of TGR Realty was to help educate individuals so that they can successfully invest in residential income property. Bob understands that knowledge always increases the probability of success. He developed a series of reports and seminars that provide individuals with the knowledge and tools necessary to make intelligent decisions.

After reading Bob's reports and attending his seminars, Bob was able to help dozens of his clients purchase properties and meet some of their financial goals.

Bob has owned over 225 rental units during his investment years. He currently has a portfolio of 47 units of which 32 have no loan. Bob has also owned several real estate management companies.

Some of the information that he has authored include:

- **How to Build a Real Estate Money Machine Seminar and Workbook**
- **What Your Real Estate Agent, Loan Officer, and Investment Guru Don't Want You to Know About Investing in Residential Income Property**
- **How to Manage Residential Income Property for Maximum Profit**
- **How to Sell Your Residential Income Property for Maximum Profit**
- **How to Live for Free**
- **How to Win the Game of Money Seminar and Workbook**
- **How to Build a Business Money Machine Seminar**
- **Getting Your Financial Bathtub in Order**
- **The Ordinary Man's Way to Wealth**
- **The Ultimate Nothing Down Cash Flow Money Machine**

Bob founded "The Win the Game of Money Institute" in 2005 to provide people with information on how to become financially independent by successfully building cash flow assets.

"One of the most important assets an investor needs to manage is their flow of information-especially their financial information. Poor-quality food affects one's health and poor-quality information affects one's wealth." – Rich Dad

On the next page is an article featuring me as a TPO Performer that was published in 2001 in the National Association of Realtor's Monthly Magazine, an organization currently with 1.2 million members.

A RESOUNDING RESPONSE

Broker Bob Ritchey of TGR Realty–Income Property Specialists, Bakersfield, Calif., used to market properties the conventional way. He'd put pictures of his listings and himself in local newspapers. Some years it worked well, but some years it didn't, he says.

His approach—and his hit-or-miss results—changed five years ago when Ritchey turned to direct response marketing.

"I'd read books about direct response marketing—how to get people to call you, and how to make more money while working fewer hours," says Ritchey, who cofounded TGR Realty in 1992. "I decided to put together a program giving people a reason to contact me."

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Ritchey created brochures offering advice on how to live free by residing in one unit of a four-unit building, how to manage property for maximum profit, and how to become a successful real estate investor.

To get the word out about his brochures, Ritchey placed ads in local newspapers and promotions on his Web site.

Now people who call Ritchey for the brochures get added to his contact list. When they want to download the brochures from Ritchey's Web site, they must first submit their name and contact information. The names, in turn, become part of Ritchey's buyer database, which he uses to market his investment property listings.

Of course, Ritchey doesn't stop with the brochures. Everyone who orders a brochure is subsequently invited to one of his seminars, which are also free.

"I give about five two-hour seminars a month," says Ritchey, who generally gets about eight people per session. "It's a way to get people in front of me who are interested in buying."

When seminar attendees are ready to buy property, they often turn to Ritchey because they learned the ropes from him.

"Real estate can give people tremendous income if they understand it," he says. "So it's good for my business to help people understand it."

Besides his direct response marketing program, the only marketing Ritchey does is a newsletter featuring his latest listings, sent every other month to his prospect list of 4,000 names.

In the past three years, Ritchey has more than doubled his income. Last year he sold almost $16 million worth of property. At the same time, though, he has been able to cut his workweek back to 35 hours.

"I hope to cut it to 25 hours," he says. "I have three assistants, and I delegate some work to them. However, I'm not just cutting back hours but also using my hours more creatively to figure out what would make my clients prefer me to any other salesperson."

When he's not brainstorming how to attract customers, Ritchey is building his own portfolio. He owns or co-owns 96 properties—everything from a two-unit rental property to a 21-unit building.

Ultimately, Ritchey, 58, hopes to pay off all his properties and then retire and live off the cash flow they generate. But he says he won't stop giving his seminars: "Making money isn't my only goal. I want to help people become financially successful."

—Leslie Cummings

Bob Ritchey

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2000 gross production volume	$15.87 million
Average sales price	$211,613
Average number of listings	20
Hours per week I work	35

GOALS FOR THIS BOOK

1) My first goal is almost impossible. Most people have a lot of difficulty accomplishing it for themselves much less helping others attain it. **That goal is to help you change the way you think and act.** This takes time and effort and getting out of your comfort zone. I can reach this goal if I can help you to modify your **BELIEF WINDOW** regarding personal and financial success. In this book I will try to get you to make financial independence one of your top priorities. I will try to convince you that you need to spend more time and effort becoming financially intelligent and building a successful portfolio of cash flow assets.

2) To have you set "Winning the Game of Money" as an important goal for you and your family

3) To help you understand the difference between net worth assets and cash flow assets and how money is made using these assets

4) To teach you through my seminars and books to know more about investing in real estate than **98%** of the real estate agents in your area.

5) To put you in a position where you won't have to trust salespeople and poor people. When it comes to money, there are many poor people trying to tell you how to get rich.

6) To help you become a professional investor, not an amateur speculator.

Over the years that I taught my live seminars, I have found that almost every attendee agrees with the principles that I teach, rates my seminar as excellent, and then goes back to doing exactly what they were doing before they were presented the information – fighting the financial war in the rat race. To invest in real estate takes some very important traits – desire, ambition, guts, goals, determination, maturity, a desire to learn, and overcoming fear.

THE TRUTH IS GREAT REAL ESTATE INVESTORS ARE MADE, NOT BORN.

I learned a long time ago about the three types of people:

1. People that make things happen.
2. People that watch things happen.
3. People that don't know what happened.

Which one are you?

INTRODUCTION TO
"THE WIN THE GAME OF MONEY INSTITUTE"

First of all, let me tell you that I am not a professional writer. English was my weakest subject in school. But I think I do have some real strengths that I want to share with you. I am smart in mathematics, analytics, and logic. I also feel that I am a good teacher and coach. I hope to share some ideas with you that I have learned and developed over the years from investing in and selling residential income property.

In the late 1990s the real estate market was not doing well. At that time I had a lot of great properties listed for sale with nice returns that were just sitting on the market with no offers. It was definitely a buyer's market for rental property. However, everyone was excited about the stock market and purchasing Internet stocks.

As I brainstormed for ideas to solve this problem, I decided to develop a two-hour seminar for the public entitled:

HOW TO BUILD A REAL ESTATE MONEY MACHINE

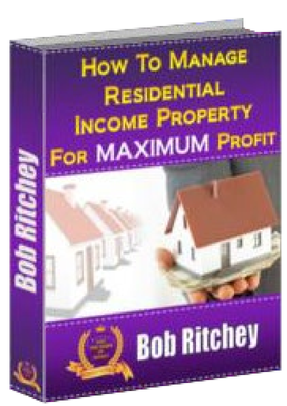
For this seminar I had two primary goals I wanted to provide to the attendees:

- **Goal #1** – At the end of two hours, the participants would know more about investing in residential income property, than **95%** of the agents in their area, and...
- **Goal #2** – To put these potential clients into a position that they would not have to trust me orany other advisors. It wasn't that I was not trustworthy. I wanted them to be able to look at aproperty and with their own knowledge, be able to determine if it was a good deal or not.

Next, I found that some of my students would purchase property and after a year or two, they would contact me and want to sell their property because of the management headaches they were experiencing. They just didn't have the knowledge to handle the challenges associated with their rental management business.

It was at that time that I decided to create another 2-hour seminar entitled:

HOW TO MANAGE RESIDENTIAL INCOME PROPERTY FOR MAXIMUM PROFIT



In this seminar I presented management information that would improvetheir chances of success and I gave them forms and letters that I used in my management company to develop the necessary relationship between them and their tenants. I eventually wrote an eBook and quit presenting this seminar.

Another interesting phenomenon that I discovered was that only about 1 out of 10 of my real estate seminar attendees would contact me to set up an appointment and start the acquisition process. I felt like a large majority of my attendees wanted to purchase real estate but they didn't have a strong enough "why!"

Well after spending some time contemplating that challenge, I decided to offer a third seminar entitled:

HOW TO WIN THE GAME OF MONEY

To Win the Game of Money, an individual needs to become financially independent sometime during their lifetime. This seminar discussed assets and the importance of passive income. It was easier for attendees to understand a "why" for taking the risk of investing for the reward of "freedom". Because of this seminar, I had more people eventually decide to purchase real estate and participate in my Internet based business.

In 2003 I retired from selling real estate. For the last several years I have had a lot of fun "playing." With the new tools that have been developed for the Internet, I have decided to "unretire" and spend some time teaching and helping those individuals that are interested to reach their success.

Next, in 2005, I decided to develop...

THE WIN THE GAME OF MONEY INSTITUTE

The "How to Win the Game of Money" and "How to Build a Real Estate Money Machine" seminars are now available on the Internet in the form of webinars. I have written a book on "How to Manage Residential Income Property for Maximum Profit." I also wrote this very book you're now reading. I will now guarantee that if you study all four of these informational materials, you will know more about investing in residential income property than **98%** of the real estate agents in your area.

My goal is to improve your chances of success by becoming a smart, well-educated investor and provide help for you when you need it.

If you are thinking about investing in real estate, you must know that there are risks involved. These risks can be reduced significantly, with the proper philosophy and the knowledge of how to apply that philosophy.

Unfortunately, over my years of selling residential income property exclusively, I have seen lots of people make mistakes.

Besides the buyer and the seller of a property, there are several other people who stand to make money if the transaction is completed. These include one or two real estate agents and their brokers, the escrow company, and the loan officer and lending company. If the escrow does not close, all of these people have committed time and effort that goes unrewarded.

I have seen people buy property based on faulty information they purchased from the so called "gurus." I have seen real estate agents encourage buyers to purchase property when the numbers didn't make sense. I have seen loan officers provide loans that were not in the best interest of the client.

I want you to be in a position that you do not have to trust other people when you make your investment decisions.

I strongly believe that the best investment you can make is to invest in yourself. Become as knowledgeable as you can in the areas that will help you and your family "Win the Game of Money!" You must try to reduce the mistakes you would make it you didn't have this information.

THE BEST WAY TO USE THE
"WIN THE GAME OF MONEY" INFORMATION
TO LEARN ABOUT INVESTING IN REAL ESTATE

There is a strategy that will give you the best chance of success that I strongly advise you follow. If you haven't already, sign up to get private access to my free video course with its accompanying study guide, plus powerful insider newsletters at our website at:

http://www.WinTheGameofMoneyInstitute.com

In those tools, you will find some of the top strategies that many wealthy individuals used to reach their financial success.

Before we get started, let me briefly share a big secret your real estate agent and investment guru don't want you to know. Whether you manage the property yourself or you have a professional property manager put in place.

Managing residential income property is a pain in the ass.

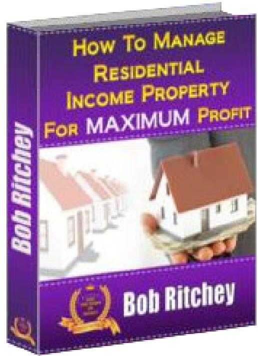
I know because I have been involved in property management for over 46 years. I have made a lot of mistakes over those years and I have seen a lot of other people make mistakes also. You are dealing with people, and in most cases the quality of those people is below average in income and civilization.

Now I will also tell you that managing residential income property can be a "BIG" pain in the ass or a "SMALL" pain in the ass.

THE DIFFERENCE IS SPECIALIZED KNOWLEDGE.

I have spent some time writing another book that I think will greatly increase your chances of success.

"HOW TO MANAGE RESIDENTIAL INCOME PROPERTY FOR MAXIMUM PROFIT"



It contains over 120 pages full of ideas, forms, and letters I have developed for my management companies over the years to maximize your yield and reduce your headaches. I divide it into 4 sections:

- **INTRODUCTION**
- **MARKETING**
- **OPERATIONS**
- **FINANCE**

Make sure you read this book along with other books on management so you reduce "the pain" as much as you can.

CHAPTER ONE:
SUCCESS BASICS
YOUR BELIEF WINDOW

In my public seminars I would ask my participants the question, “Do you want to become wealthy? “ Most would say, “Yes!”

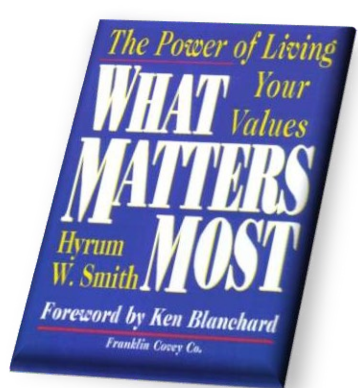
Next I would ask them the question, “Why aren’t you already wealthy?”

Well I got lots of answers (excuses) as replies. May I suggest that the reason most people are not wealthy is because they don’t think like wealthy people. They do not have the belief patterns that wealthy people have. Therefore, they don’t take the actions wealthy people take. AND BEFORE THEY OR YOU CAN BECOME WEALTHY, YOU WILL PROBABLY HAVE TO CHANGE A LOT OF THE BELIEFS THAT YOU CURRENTLY HAVE. Here are some notes from a great book that I hope you will review before we go on any further.

What’s on Your Belief Window?Hirum W. Smith from his book “What Matters Most”

“We don’t see things as they are, we see things as we are.” – Anais Nin

“As the happiness of real good men consists in right action, and right action cannot be produced without right opinion, it behooves, above all things in this world, to take care that our own opinion of things be according to the nature of things.” – Benjamin Franklin



The changing of long-standing negative behaviors is difficult to achieve. Many of the decisions that we make and how we behave in different situations is caused by what is written on our **BELIEF WINDOW.**

You cannot actually see your Belief Window because it’s invisible, but we all have one. It is figuratively attached to your head and hangs in front of your face. Every time you move, the window goes with you. You look at the world through it, and what you see is filtered back to you through it.

Your Belief Window helps you make sense of the world around you. It influences the way you perceive others, the way you read situations, and the feelings you have about yourself. And if there is information you do not wish to “see” or acknowledge, you use you Belief Window to filter it out and keep it away from you.

The tricky thing about the Belief Window is that you have placed perceptions on it which you believe are absolutely true, whether they reflect reality or not. For example, your experiences and social feedback may have caused you to believe that you are smart, stupid, beautiful, ugly, competent, incompetent, creative, or dull – regardless of whether they are true. And because you believe them, you unquestioningly act as though they are.

As you can see, the Belief Window exerts a powerful influence on our actions and behavior. That's why changing our behavior is sometimes such a difficult task. Erroneous perceptions on our Belief Windows can be a major detriment to our efforts to get our action more consistent with our most deeply held values.

Until we realized that we view the world through our Belief Windows and that it constantly filters our experiences, we will continue to think that we see life "as it really is." But unless our Belief Window truly reflects reality – things as they really are, not as we wish they were or think they should be – we find that we can easily fool ourselves and potentially damage our chances for success in any activity we undertake.

One of the most important things we can do is make sure our Belief Window is as clear as possible and truly reflects what is happening in our life. Ask yourself, "What is on my Belief Window with regards to my beliefs about health, money, financial success, strengths and weaknesses?" Do you recognize that some of the things you've placed on it may be incorrect? In doing so you will have achieved the critical first step in freeing yourself from erroneous self-ideas and self-talk that may be impeding your progress.

Everyone has a mix of correct, incorrect, and debatable beliefs on their Belief Window. All of them influence behavior. The key is to identify the beliefs on our Belief Window and change those that are incorrect or inadequate.

Belief Windows Define Our Limits and Set Our Capabilities

The beliefs on our windows set parameters for our success and happiness.

Your Belief Window Influences Your Actions

For each belief on your window you subconsciously create mental rules that govern your behavior. These rules are "if-then" statements that translate your beliefs into actions. More often than not, these rules exist only at a subconscious level, but they do exist.

Results and Feedback

What are the results of your behavior? And, more important, will those results meet your needs? If the results of your behavior do meet your needs, you could say that you have a correct perception on your Belief Window. If they do not, this suggests that you should take a closer look at both your needs and the belief you are using to try to satisfy them. But how do you really know whether or not your needs are being met by a certain belief? Well, the only way you can know for sure is to put the behavior to the test of time. Results often take time to measure.

The process of amending our beliefs happens all the time. It's called experience.

Results Often Take Time to Measure

The results of many of our actions may take years to become evident. Sometimes we can operate on any incorrect assumption, get lucky, and manage to beat the odds. For this reason it is often wise to perform two tests on some of our beliefs - one through our own experiences and one through the experiences of others.

Growth is the Process of Updating Your Belief Window

We might say personal growth is the process of challenging and updating what is on your Belief Window. The first step is accepting the possibility that some of the things on your window are wrong. The willingness to do this is a sign of maturity.

Using the Belief Window to Change Behavior

There are four human needs*: to live, to love and be loved, to feel important*, and *to have variety in our lives.*

Please understand that when any of our basic needs are not being met, all of our energy automatically flows to meeting that need. We start putting beliefs on our window that we think will help us meet those needs. If we put a belief on our Belief Window that drives behavior that works short–term but destroys in the long-term, will we continue the behavior? Yes, we will, or at least many of us will, unless we decide to recognize and take control of the needs and beliefs that are underlying that behavior.

When you witness a pattern of behavior, you can tell what's on the Belief Window.

I did not come here to tell you what belongs on your Belief Window. That's none of my business. I came to tell you that you have a Belief Window. You have the same needs I have, and you're putting things on the Belief Window every day that you think are going to meet your needs. Are you man enough to take that window off, put it on the table, and find out if those beliefs are correct?

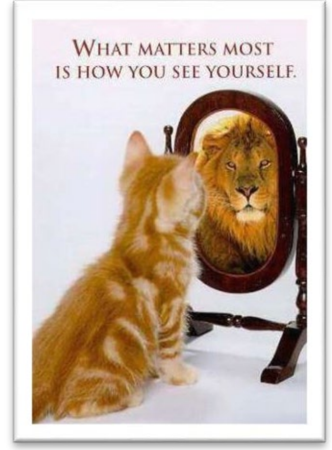
The Belief Window places responsibility for behavior right smack on the individual where it belongs. **I believe that there arrives a point in time when we must take total responsibility for our behavior. You are responsible for what stays on your Belief Window. The thing that separates you and me from the rest of the animal kingdom is that we can change our Belief Window.**

We all have needs. We all have Belief Windows. We have set up internal rules based on those beliefs, and these drive our behavior. The trouble is that we tend not to measure the results and ask the change-initiating question:

"Will the results of this behavior meet my needs over time?"

Take the time to examine closely what is on your Belief Window. If you find beliefs or perceptions that are hindering you and holding you back, remember that they can be changed for beliefs that will serve you better. The closer your belief and perceptions are to reality, to things as they really are, the more successful you will be in meeting life's challenges and in living in accordance with what matters most.

MAY I SUGGEST THAT YOUR FIRST ACTION SHOULD BE TO MAKE ACOMMITMENT TO LOOK AT YOUR BELIEF WINDOW AND FIND THOSE BELIEFS THAT MUST BE CHANGED FOR YOU TO EXPERIENCE BOTH PERSONAL AND FINANCIAL SUCCESS!



I will be talking about your Belief Window throughout this seminar. It is the most important element that determines your financial success or your financial failure.

THE TRUE STORY OF LIFE

One of the valuable things that I learned several years ago was a story that teaches the TRUE STORY OF LIFE!

I would you like to share this important story with you at this time.

There was a king that lived several hundred years ago and he was contemplating how he could distinguish himself from all the other kings that had lived. He saw that other kings had left statutes, paintings, and castles. What could he leave behind that would be "unique" and "set him apart?" Finally he decided that he would leave mankind the TRUE STORY OF LIFE.

He called together all the wise men of the country and told them his plan. They would go out all over the world and spend five years researching for the answer. Then they would return to the kingdom and write down what they had discovered.

The five years passed by and the wise men returned and met in a great room to discuss their findings and start writing down the TRUE STORY OF LIFE. Finally, after another 5 years, the wise men told the king they had completed their work and the wheeled out a big table with 20 big thick books on it.

The king looked at it and told the wise men that it was too long, that no one would read it, and that they would have to condense it down.

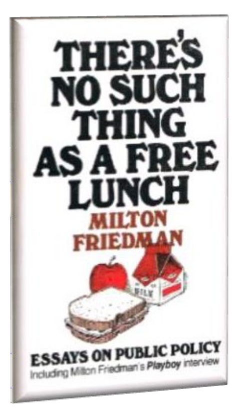
Five years later, the wise men again went to the king and this time they had one big thick book. Again, the king told them that it was too long and they have to condense it one more time.

Another 5 years passed and the wise men came to the king and they had one page and on the one page was one sentence.

The king read the sentence and pronounced that the sentence was in fact, the TRUE STORY OF LIFE.

The sentence said:

THERE IS NO FREE LUNCH!



One of the biggest mistakes people make and gurus take advantage of is the belief that a person can become wealthy in a short period of time with very little effort. They try to convince you

"That you can get something for nothing."

If this belief is on your Belief Window, make an effort to remove it immediately.

ONE MORE QUICK STORY

One day an old friend of Bruce named Allen pulled up to him in a brand new red Ferrari. Bruce noticed Allen had very expensive clothes on and a large diamond ring on his finger. Bruce knew that Allen had lived a middleclass life and so he asked Allen what happened. Allen told Bruce that he had discovered a gold mine close by and that since Bruce was such a good friend, Allen would tell him were the mine was and he could go and dig up as much gold as he wanted.

A few days later, Allen stopped by Bruce's house to see how he was doing. He asked Bruce how much gold had he dug up from the mine. Bruce told him he hadn't dug up any. Allen asked him "Why Not?"

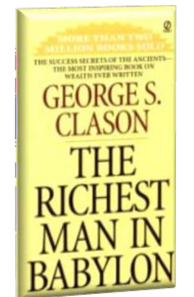
Bruce stated, "Have you seen the costs of shovels?"

THERE ARE PEOPLE THAT MAKE MONEY AND THERE ARE PEOPLE THAT MAKE EXCUSES.

WHICH ONE ARE YOU? WHAT'S ON YOUR BELIEF WINDOW?

THE RICHEST MAN IN BABYLON

SEVEN CURES FOR A LEAN PURSE



One of the most basic yet powerful books ever written on financial success was written by George S. Clason in 1926 entitled; "The Richest Man in Babylon."

Babylon became the wealthiest city of the ancient world because its citizens were the richest people of their time. They appreciated the value of money. They practiced sound financial principles in acquiring money, keeping money and making their money earn more money. They provided for themselves what we all desire…incomes for the future.

A composite of many stories, the first story introduces Arkad, the richest man in Babylon, who explains the "Seven Cures for a Lean Purse.

1. Start Thy Purse to Fattening

The first thing you must do to become financially independent is to save part of your income. It is recommended that it be at least 10% of your gross income. When you pay your bills, make the first check for the 10% payable to you. Always pay yourself first.

2. Control Thy Expenditures

If you are going to live on only 90% of your income instead of 100%, you are going to have to budget. Buy necessities only at first and then buy luxuries with what's left over. Remember, to allow for emergencies.

3. Make Thy Gold Multiply

Use your savings to make profitable investments. The key is to get a compounding effect. Continue to reinvest your profits.

4. Guard Thy Treasures From Loss

Seek expert advice. Don't ask the garbage man what to invest in. If you want to buy stock, find the best stockbrokers. If you want to invest in real estate, seek real estate agents who are expert in the investment field.

5. Make Of Thy Dwelling A Profitable Investment

Your home is also an investment. If you are presently renting, you should consider purchasing a home, unless there are special circumstances that prevent you.

6. Insure A Future Income

Buy insurance to protect having to disturb your investment plans. You should have adequate life, health, automobile, and homeowners insurance. Put yourself in a position so that if an emergency should arrive, you will not have to dip into your investment portfolio to take care of it. Also, remember that insurance is for the protection of your assets, and not an investment vehicle.

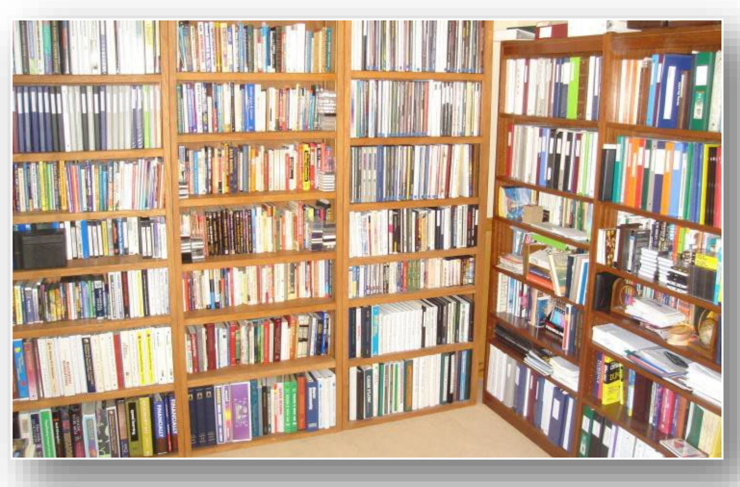
7. Increase Thy Ability to Earn

To earn more money, you must provide a better service or product than you are presently providing. This can only be done by increasing your skills. Continue to grow every year.

<u>If you follow these seven principles, I guarantee you'll become financially independent.</u>

IF YOU DON'T SAVE AND INVEST YOUR MONEY, YOU WILL NEVER BE WEALTHY!

My library of books on personal and financial success.



WHAT THE GURUS DON'T WANT YOU TO KNOW

I see infomercials all the time on TV for courses on creating wealth in different asset classes. They have good looking women in low top outfits interviewing individuals who had made $35,000 in 15 minutes. Just purchase their program and the money will start rolling in.

I remember when I would see a full page advertisement in the newspaper or a commercial on TV that some guru was going to have a "free" seminar open to the public in my city and they were going to give away material to those that attended worth "hundreds of dollars." Then, they would present some teaser information and try to get you to sign up for training classes costing thousands of dollars.

Now, if you haven't learned by now, you know that I am a big advocate for investing in knowledge. You just have to be real careful what you invest in. I always check out these gurus on the Internet looking for independent reviews. I also go to eBay and see if I can purchase their material for a lot less than the retail cost.

Next, what do you do with this material, including mine? Do you just believe every word blindly or do you use common sense. Based on my 34 years of investing and selling real estate, I am very skeptical regarding most of the information that is out there. Most of these gurus "over promise and under produce!" Later I will recommend how you should evaluate these programs and books based on the information that I will be teaching you on the two major types of assets.

Of all your assets, your mind is your greatest, so you need the best advice possible.

“The primary reason people struggle financially is because they take financial advice from poor people and salespeople.” – Rich Dad

I will give you an example. I could write a book entitled “How You Can Own $10,000,000 of Real Estate in One Month Using None of Your Own Money With My Proven System.”

That sounds like a book people would buy. Could it be possible to do? I think so. The book could have just two chapters.

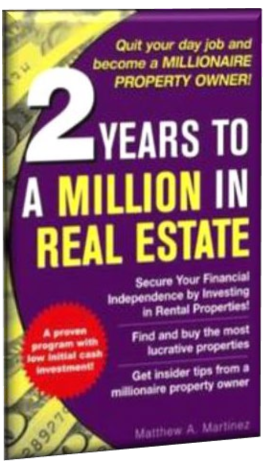
Chapter 1 - You just advertise. I’m sure you have seen signs on all over the place, “I buy homes” and “Stop Foreclosure.” You are looking for people that recognize that they can no longer afford their homes and are starting to panic. They don’t want their credit negatively affected and they really don’t want the bank to lose money. According to the latest published numbers, about 25% of all the homes in the United States are upside down (loan greater than value of home.) More and more homes are going into foreclosure.

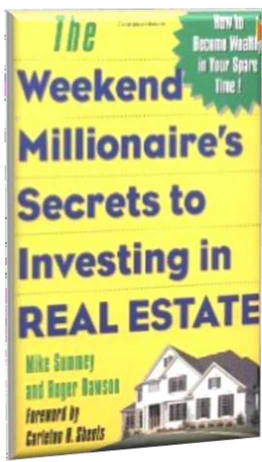
Chapter 2 – Once an owner calls you, you tell them that if they will deed their property over to you, you will make the payments on their property. This will stop the foreclosure so their credit will be protected. You will find all kinds of people with properties that will take that offer. You draw up the grant deed, have them sign it, and record it and you own the property.

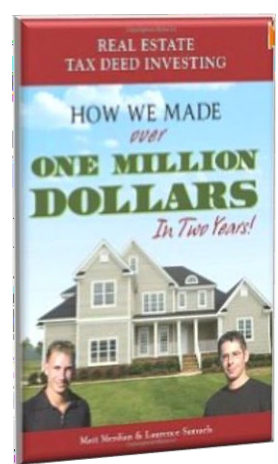
There you have it. A simple way to own a bunch of real estate.

The question is, “What are you going to do with the property once you own it?” You can’t sell it for a profit. You can’t rent it for a profit. You are in the same position as the previous owner.

BEWARE OF THE GURU’S THAT MAKE IT SOUND TOO EASY. Does what they are teaching really make sense. Check their motives. Having the wrong belief on your belief window when it comes to this area can be very costly.







DEFINITIONS

I would like to share some definitions with you that you should be familiar with if you have studied my seminar material.

Success – the progressive realization of a predetermined worthwhile dream or goal.

Money – a measurement of the quality and quantity of service or product you provide society.

Net Worth – your assets minus your liabilities – what your own minus what you owe.

Wealth – when your assets minus your liabilities is a large number.

Financial Independence – having enough income independent of your time to live the lifestyle you want to live whether your work or not.

Earned or Linear Income – income based on trading time for money.

Passive Income – income derived from real estate or businesses.

Portfolio Income – income from paper assets.

Residual Income – passive and portfolio income.

Speculator – someone that assumes a risk in expectation of profiting from market fluctuations; to take to be true on the basis of insufficient evidence; to theorize.

Investor – to commit money with knowledge in order to earn a financial return.

CHAPTER 2
FINANCIAL BASICS
HOW GOOD ARE YOUR MATH SKILLS?

I have to stop here and tell you that this book is going to have a lot of mathematical calculations as part of the learning process. I have tried to make them as simple as possible and in many cases the numbers are not what are important, the concepts that are deducted from the numbers are the lessons that I am trying to teach.

I will spend a great amount of time teaching you how to calculate a yield for a residential income property. In many cases, your real estate agent will prepare forms that show how the property should perform. However, you need enough knowledge to be able to answer the question, "Does this make sense?" and know how to get any of the numbers used in the calculations from accurate sources so that you don't have to trust your agent.

Let's start with a couple of easy but important calculations that we will use in our book.

HOW TO DETERMINE YIELD

Yield is the profit you make on an investment (normally over a one year period) expressed as a percentage. You might remember basic math where you had the formula for finding interest.

I = PRT - SIMPLE INTEREST = PRINCIPLE X RATE X TIME

Interest is the amount of money you will earn during the time that it is invested.

Principle is the initial amount of money that you invested.

Rate is the yield expressed as a percentage that you receive on your principle

Time is the length of time you have the principle invested.

There is another type of interest called compound interest. We will not be spending much time discussing this concept but it applies throughout this whole book.

Example: You put $1000 in a savings account that pays 5% interest per year. To determine the amount of interest you will earn for one year:

Interest = 1000 X .05 X 1 = $50

To find the yield on an investment for one year, you would use the formula

RATE (YIELD) = INTEREST ÷ PRINCIPLE

Example: You put $2500 into an investment and at the end of one year you have earned $375.

Yield = 375 ÷ 2500 = .15 = 15%

THE RULE OF 72

Another financial calculation involves the Rule of 72. With it, you can:

1. determine how many years it will take to double your money at a certain percentagerate
2. determine what interest rate you would need to produce to double your money in a certain number of years.

$$\textbf{Percentage} = \frac{\textbf{72}}{\textbf{Number of Years}}$$

$$\textbf{Number of Years} = \frac{\textbf{72}}{\textbf{Percentage}}$$

Example: How long would it take to double your money with a yield of 4% per year?
Answer: 72 ÷ 4 = 18 years

Example: What interest rate would you need to generate to double your money in 5 years?
Answer: 72 ÷ 5 = 14.4 %

The problem with the rule of 72 is that it doesn't take into effect three negative influences on everyone's investment endeavors – inflation, yearly taxes and taxes upon sale. In order to get a certain true yield, we should consider having to get a higher yield than we calculate using the Rule of 72.

If we have a goal to earn 10% and the inflation rate is 3.5% for the year and we have to pay 25% taxes on our interest earned, we will have to earn a lot higher rate of return.

Example: We have $1000 invested at 10% interest. Our $1000 loses 3.5% of its buying power because of inflation so at the end of one year it is only worth $965. We earn $100 interest but have to pay $25 in taxes, leaving us with $75. We really have left $1040 which is only a 4% yield.

Example: We purchase a $100,000 property with 20% down, $20,000. We have a 5% cash on cash return ($20,000 X .05 = $1000). The $1000 is not taxable because the depreciation of the property cancels it out. At the end of the year the property is worth $103,500 (a 3.5% increase due to inflation). Our gain on the property is $1000 + $3500 or $4500. Our yield, $4500 ÷ $20,000 is 22.5%. (We did not take into account the principle reduction and the application of additional depreciation to our ordinary income which would increase our yield even more.)

CHAPTER THREE
HOW DO YOU WIN THE GAME OF MONEY?

One of my favorite authors is Robert Kiyosaki, author of the Rich Dad series of books and developer of the games Cashflow 101, Cashflow 202, and Cashflow for Kids.

In one of his books he discusses the Game of Money and how to win it. First of all, to Win the Game of Money means to become **financially independent**.

Financial independence means to have enough income coming in every month, **independent of you time**, that you can live the lifestyle you want, whether you decide to work or not.

A large percentage of the population is only focused on today. Month after month, they get paid, spend their money, and wait for the next pay check. They procrastinate about the future hoping that some miracle will happen such as winning the lottery.

Most people believe that they are winning the game of money if they have enough earned income to pay their bills. They know that they are in the “rat race” but they are staying up with the Jones.

YOU CANNOT WIN THE GAME OF MONEY WITH EARNED INCOME.

In Rich Dad, Poor Dad, Kiyosaki defines two very important words”

ASSET – something that puts money into your wallet

LIABILITY – something that takes money out of your wallet.

His books are designed to teach you to focus on the accumulation of assets that produce passive and portfolio income; residual income. When your residual income is greater than your expenses, you are financially independent. You have **Won the Game of Money**!

In all the live seminars that I use to teach, I asked my attendees if they wanted to be financially independent. I can’t remember any of them saying “No!” Who wants to end up being dependent on the government, charity or their family to survive during their lifetime?

YOUR WEALTH RATIO

Another interesting concept that Kiyosaki discusses is a way to measure where you currently stand, your score, when it comes to winning the Game of Money. He starts by asking the question, if you went to a bank and applied for a loan, would the loan officer ask you for a transcript of your grades from high school or college. **Of course not!**

The loan officer would be interested in your financial grades. These include:

- **Your credit report**
- **Your income and expense ratio**
- **The amount of money in your savings account**
- **The amount you owe on credit cards, and other personal debt**
- **Your Wealth Ratio**

YOUR WEALTH RATIO =
YOUR PASSIVE INCOME + PORTFOLIO INCOME
÷ YOUR YEARLY EXPENSES

Example: You own some stock that pays you $2500 per year in dividends. You also have a note that you purchased that pays you $1750 per year. And you have a rental house that creates $2400 income per year. Your expenses for the year are $36,000.

Your Wealth Ratio would be: $2500 + 1750 + 2400 ÷ 36,000 = .185

This means that you are 18.5% of the way to financial independence. Now if you are a young man, that might be pretty good score, but if you are middle aged or above, you have a lot of work to do.

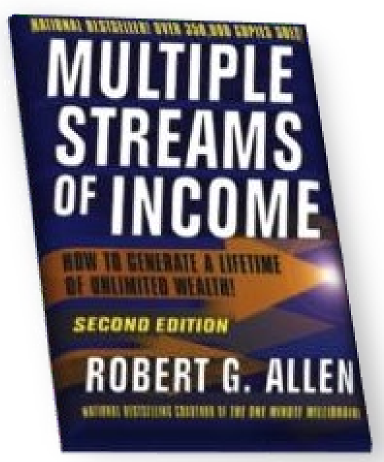
YOUR WEALTH RATIO MUST BE GREATER THAN OR EQUAL TO 1.

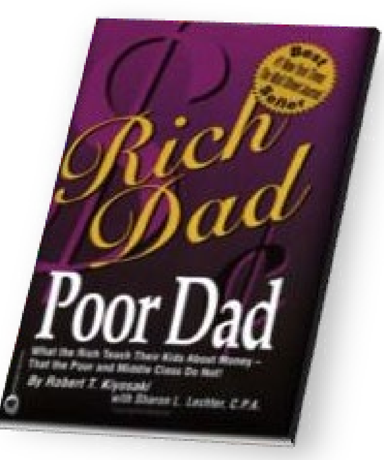
The Win the Game of Money Institute is dedicated to helping as many people as possible to learn about and purchase or develop assets, cash flow assets, assets that will provide the residual income necessary to obtain a Wealth Ratio greater than 1.

In this book we are going to discuss using real estate as the asset to build our passive income towards this magic ratio.

By the way, do you think it would be smart to reach a wealth ratio of 1, and then stop? I think it would be smarter to get it up to 2, or even 3, just for added security.

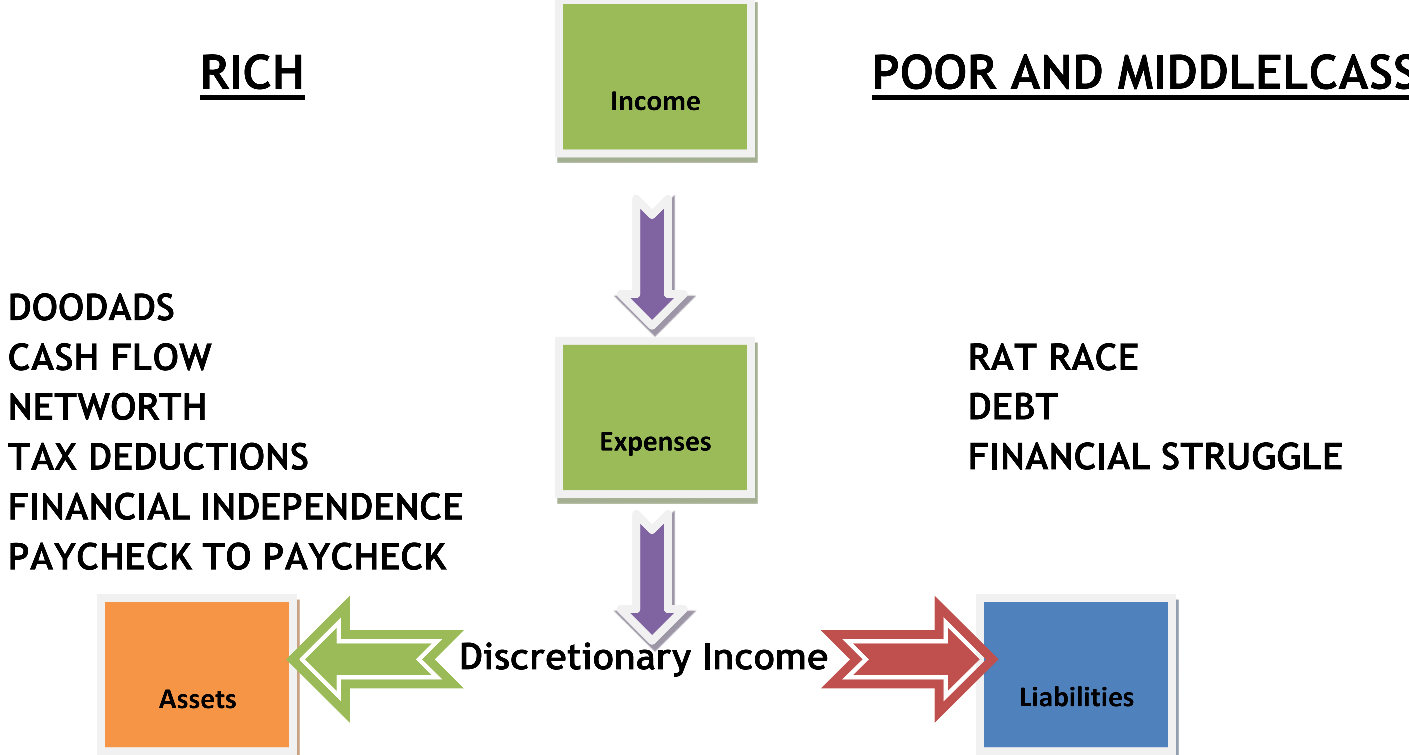
I would also strongly advise that you don't have all your eggs in one basket. You will see what happened to me later in this book when I didn't follow this advice and diversify. One of my mentors, Robert Allen, is a big proponent of and taught me the importance of having **MULTIPLE STREAMS OF INCOME.**





ROBERT KIYOSAKI'S TWO MODELS

If you watched the Win the Game of Money Institute's two seminars on "How to Win the Game of Money" and "How to Build a Real Estate Money Machine," you will be very familiar with the two models taught by Robert Kiyosaki in his books Rich Dad – Poor Dad and The Cashflow Quadrant.



We have learned that the poor and middleclass focus on the income box and then spend their discretionary income purchasing liabilities and doodads.

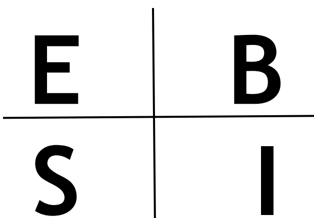
The wealthy focus the use of their discretionary income to purchase or build assets.

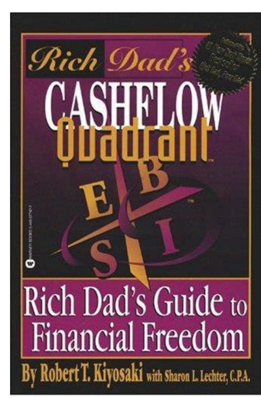
"Be Smart! Don't trade you future wealth for short term gratification. Trying to live like you are rich when you're not is the surest way to end up poor." - Mark McKee - Investor and Real Estate Trainer

"To have a job and be an employee, working hard for something you will never own and could never sell. And if you stop working, the cash flow would stop." - Rich Dad

"How do you spend your time? Are you working for money - or are you working to buy or create assets that will generate money for you? You may want to adjust the way you spend your time." - Rich Dad

From the Cashflow Quadrant we learned that it doesn't matter if you are an employee or self-employed, you need to come over to the business and investment quadrants and acquire assets.





WEALTH VS POVERTY

The basic rule for the accumulation of wealth is: produce more than you consume. The United States became the wealthiest country in the world because its citizens knew how to work hard and produced products that we sold to ourselves and other nations. We had a large positive trade balance and other countries borrowed money from us. Families enjoyed a comfortable life style with only one wage earner. Taxes per family were lower, because almost all the people produced.

Since the 1960's, America started a trend of consuming more that it produced. From a trade surplus, it went to a giant trade deficit. From a country where almost all of our citizens worked to produce, it has gradually become a welfare country, where a large percentage of our citizens receive money from the government when they don't produce. Those people who produce in America have seen more and more of their production taken away from them by the government in the form of taxes and given to the non-producers. Now it is hard for families to make ends meet even when both spouses work.

Another challenge that Americans personally face is the ability to borrow money easily. Even though a family does produce, it is bombarded with advertising messages to purchase liabilities that are not necessities. If a family gets greedy, it can spend more that it produces through the use of credit. Credit is money loaned to you now that you pay off with your production of the future. One of the biggest mistakes made by Americans is to purchase a liability on credit. You are paying interest on something going down in value. Our citizens now wonder why they have to participate in the rat race for 40+ years and then retire on social security.

Remember the rule for wealth applies both to America and its citizens:

Always produce more than you consume.

Put this idea on your Belief Window.

NET WORTH ASSETS VERSUS CASH FLOW ASSETS

Of course, there are all kinds of assets for sale in the market. Kiyosaki divides assets into two categories based on the type of return they produce. One type of asset is what is called a "net worth" or "capital gain" asset. The other is called a "cash flow" asset.

Net Worth Asset (Capital Gain Asset) – something that you purchase with the hope of it rising in value.

Cash Flow Asset – something that you purchase that produces cash flow, whether it goes up or down in value.

Speculators focus on putting their money into Net Worth (Capital Gain) assets. Smart speculators will use the premise of buy low, sell high. Unwise speculators will see an asset class go way up, and think that it is smart to start buying at the top.

Investors purchase assets first for cash flow. Smart investors will still use the buy low, sell high philosophy but will consider appreciation as a bonus yield, not the primary yield.

There is a saying that you might have heard, "What you don't know, won't hurt you!" Whoever said this is one of the biggest fools in the world. Another popular saying which is just as stupid is "Ignorance is bliss!" I think that both of the people who originated these statements are "speculators."

"Success is not a matter of luck or accident or being in the right place at the right time. Success is as predictable as the sun rising in the east and setting in the west. If you consistently and persistently do the things that other successful people do, nothing in the world can stop you from becoming a big success yourself. You are the architect of our own destiny. You are the master of your own fate." – Brian Tracy

"Ignorance is free but the upkeep is tremendous." - Donald Beck

Why are capital gains so easy to sell? "The propensity to gamble is always increased by a large prize versus a small entry fee, no matter how poor the true odds may be." – Warren Buffett

HOW TO BE A GREAT INVESTOR?

"You need two professions. One for you and one for your money. Look at your money as employees. Your job as an investor is to find the right profession for your money…your employees. Educate yourself, so you can treat your workers with respect, find them great places to work, protect them, make sure they are paid well, and your workers will multiply and work hard for you." Rich Dad

GOOD INCOME VERSUS BAD INCOME

TYPES ON INCOME

I learned several years ago that "**not all income is good income**." I also learned there was a difference between "**working hard and working smart**." If all it took to Win the Game of Money was hard work then all brick layers and housewives would be winners. Let's discuss some ideas using common sense.

Have your ever heard the saying. "**TIME IS MONEY**?" This is definitely true for certain people. As a real estate agent, I know that I have to spend time doing productive actions to find and work with buyers and sellers. A doctor knows that he makes no money unless he sees patients. Employees and self-employed people work for money.

Now there is one big problem with trading time for money.

When you don't trade your time, you don't make any money!

When you stop, it stops. Even if you want to work, they may be no demand for your time. Just ask the large number of unemployed people that exist today.

Money earned by trading time is called **earned income**. Rich Dad calls this **BAD INCOME** and I agree 100%.

I used to ask my seminar attendees this question:

"If you wrote down twenty favorite things that you would like to be able to do any day you want, would **WORK** by on your list?" It wouldn't be on mine. I feel sorry for people who only live to work and have no other interests or hobbies. When you **Win the Game of Money**, you will have the choices to do those activities that you want to do, not have to do.

I was blessed early in my career to understand that besides working, I needed to spend some time building another type of income, **PASSIVE or RESIDUAL INCOME**, income that was not dependent upon my time. Another name for this type of income is "**CASH FLOW**!"

According the Rich Dad, CASH FLOW is the most powerful financial term.

This type of income is **GOOD INCOME**!

A lot of people that fill out their tax returns use the short form because they only have earned income and not enough tax write-offs to file long form. They only have BAD INCOME.

People with GOOD INCOME have more pages to file each year with the IRS. Pages like Schedule C for businesses and Schedule E for real estate investments. Here are some important ideas to place on your BELIEF WINDOW.

TRADING TIME FOR MONEY PRODUCES EARNED INCOME.

EARNED INCOME IS BAD INCOME.

INCOME DEPENDENT ON YOUR TIME IS BAD INCOME.

TO WIN THE GAME OF MONEY, YOU MUST PRODUCE CASH FLOW.

CASH FLOW IS GOOD INCOME.

CASH FLOW IS PASSIVE INCOME.

CASH FLOW IS RESIDUAL

INCOME.

CASH FLOW GIVES YOU BOTH TIME AND MONEY.

THIS IS HOW TO BECOME FINANCIAL

INDEPENDENT DON'T QUIT YOUR JOB, BUT START

GOOD DEBT VERSUS BAD DEBT

We learned in our discussion of the Belief Window that most people in the United States have developed beliefs that are counterproductive to them ever winning the Game of Money.

The first belief that most people have is that we need all of the latest toys, trinkets, and bobbles that are being produced, mainly by foreign countries. We are taught from a very young age to be CONSUMERS. Our clothes have to be a certain brand. If we don't have an iPod or IPhone, we are not with it. A living room is not a living room without a large flat screen TV with HD. We have heard all about the large balances on people's credit cards.

There are programs advertised every day telling you if you have over $10,000 in personal debt or own money to the IRS, some company will negotiate the balance and payment significantly lower if you pay them some money. Every time a credit card company or the IRS discounts the amount of money they are owed, they are rewarding irresponsible people. This has been also evident when the government takes our tax money and bails out Wall Street, banks, and car companies that were irresponsible with their investor's money. We have had the government participate in "Cash for Clunkers" and help for people with incentives to purchase homes which again waste our tax dollars.

Well I agree that this type of debt is bad and almost "evil." Why should we live today on money we will have to earn in the future? **HAVING BAD DEBT IS WORSE THAN BEING POOR**.

Definition – Bad Debt – any debt that is incurred by purchasing liabilities. Debt that has to be paid from an individual's personal income.

My wife is from Guadalajara, Mexico, and the first time I went with her to visit her family was pretty eye opening. They live in a highly dense residential area and we arrived after dark. The next morning I woke up and looked out the front door. In front of the house were a donkey and a cart. As I walked around the neighborhood, I noticed a lot of houses that were under construction. I could see where a concrete floor was laid and then maybe a wall or two was built with adobe bricks. Some houses had all the walls completed but no roof. Almost none of the houses had anyone working on them at the time. I asked by brother-in-law why the houses were incomplete. He told me that the interest rate to borrow money from a bank in Mexico is very high and that the property owners have tosave cash up to apply to the construction. A family will save for a few months, buy some bricks, and put up a wall. Then wait another few months until they had some more money to build another wall. It takes years in some cases for the completion of a house.

Things are sure different in this country. The average time to complete a house is 3-4 months. We have low interest, long-term loans that we can obtain relatively easily. But let me ask you a question:

What would happen to the lifestyle of our country if the citizens could not borrow money?

In my opinion, all debt is not bad debt.

Definition – Good debt – any debt that is used to purchase a cash flow asset where the income from the asset is greater than the cost of servicing the expenses of the asset. Debt that produces a net positive cash flow. (We will spend most of the rest of this book on this type of debt.)

In fact on the next couple of pages I want to explain how to make credit cards an asset.

Credit Cards – Assets or Liabilities

Credit cards have become a great problem for a lot of people in this country. It is so easy to obtain a credit card. I see banks down at the Lake Tahoe Junior College setting up booths and trying to sign up 18 and 19 year olds.

As I told you earlier in Kiyosaki's book, "Rich Dad – Poor Dad, What the Rich Teach Their Kids That the Poor and Middle Class Do Not" you will find a very simple definition of an asset and a liability.

An asset creates income.
It puts money
into your wallet.

A liability costs money.
It takes money
out of your wallet.

It is important to know the difference between assets and liabilities.

Based on this definition is your home an asset or liability? Does it put money into your wallet or take money out of your wallet and you give it to the bank or mortgage company?

Is your car an asset or a liability? Your children?

Now I am not saying that you should not have liabilities. I am saying you need to know what an asset is and what a liability is.

A lot of undisciplined people have credit cards that they abuse. They have the philosophy of buy now and pay later. They have no delayed gratification. They are brainwashed by all the advertisements they see to live a lifestyle beyond their means. This philosophy eventually leads to negative results such as having their possessions repossessed, bankruptcy, and ruined credit.

Unless you have a philosophy of living below your means, you don't deserve the ability to use credit.

Here are some of the negative results of having a credit card.

1) You pay interest – high interest. My card charges 13.49% on purchases and 18.99% on cash advances.
2) You pay large penalties if you don't make your payment on time
3) You can pay a yearly fee for the use of the card
4) You credit can be ruined. If you don't make payments on time, the credit card company reports it to the credit agencies and you get a negative comment on your credit report.

For years, I used a credit card to purchase things and then made my minimum payment because I didn't have enough money to pay it off.

Then I learned a few things and changed my Belief Window. I learned how to make a credit card an asset. For this to happen, you must **pay off you credit balance every month**. My credit card now gives me valuable benefits.

1) I am borrowing money at no interest. The best case scenario is that I charge an item on the first day of my cycle and I have to pay it for it 56 days later. The worst scenario is I purchase something on the last day of my cycle and pay it off 25 days later. All this time, my credit card company has lent me the money and when I pay on or before the due date, I owe no interest for this loan that they made me.
2) Earning rewards. Many cards offer incentives to use their cards. You have cash back, airline tickets, hotels, gas price reductions, and much more.

My personal credit card is from Capital One. As I make purchases, **I earn a 1.5% cash back reward. It is an asset for me. In puts money into my wallet.**

WHO WANTS TO BE A MILLIONAIRE?

Let me share another definition with you but first let me ask you the question...

"Would you like to become a millionaire?"

This provided an interesting response when I asked my seminar attendees. About 90% would raise their hand. I think that the 10% who kept their hands down were hung up on the fear that becoming wealthy was a sin. (BAD BELIEF) To become financially independent and Win the Game of Money, you will have to accumulate assets. When you quit work, your earned income stops. You must have either enough net worth assets that you can sell to provide you money to live on until you die or you must have cash flow assets producing your retirement income. Both of these types of assets have value, net worth, which creates wealth for an individual.

In my opinion, it is not a sin to be wealthy. It is a sin to be financially dependent on individuals or the government.

It is your responsibility to have enough wealth to become financially independent.

I truly hope you will put this belief on your Belief Window.

We already defined net worth as a person's assets minus their liabilities.

How would you define the term "MILLIONAIRE?" The conventional definition is:

Millionaire - an individual that has a net worth of at least one million dollars.

To be honest, I don't like this definition of millionaire. I will share my definition in a minute but first let's talk about the power of the **TENTH MULTIPLE.**

THE TENTH MULTIPLE

One of the first programs that I purchased to study was produced by Success Motivation Institute entitled HOW TO BECOME FINANCIALLY INDEPENDENT. Introduced in the very first chapter was the principal of the Tenth Multiple. This may be a concept you are already familiar with, but one that must be emphasized. Let's suppose you have been saving 10% of your income and you now have $1,000 to invest today. You pick an investment vehicle that will double your money in 3 years. What yield would you need? Using the Rule of 72, 72 ÷ 3 = 24%. So after 3 years you now have $2,000. Let's do it again. At the end of 6 years, you will have $4,000. Let's continue. At the end of 9 years, your $1,000 will grow to $8,000; 12 years will be $16,000 and at the end of 15 years, or the 5th multiple, gives you $32,000; a tidy sum but hardly enough to claim financial independence. But let's do the same thing for 15 more years, or a total of 10 multiples. You would then have $1,024,000. That's right, you'd be a millionaire!

Initial Investment $1000

1st Multiple	**$2000**
2nd Multiple	**$4000**
3rd Multiple	**$8000**
4th Multiple	**$16,000**
5th Multiple	**$32,000**
6th Multiple	**$64,000**
7th Multiple	**$128,000**
8th Multiple	**$256,000**
9th Multiple	**$512,000**
10th Multiple	**$1,024,000**

Can't wait 30 years? If you started with $10,000 instead of $1,000 it would take you approximately 20 years. Also, if you invested $1,000 each year instead of just the initial $1,000 and followed the same procedures you would reach the $1,000,000 plateau in a lot less than 30 years. Of course, you can reach it in less time if you double your money in less than 3 years.

In making investment decisions, keep in mind that one of your goals is to safely double your money as quickly as possible. Remember the TENTH MULTIPLE.

When I learned this concept, I quickly placed it on my Belief Window.

Of course this theory is based on yield from net worth assets. I will show you how leverage will increase yield and how to determine yield shortly. **But this theory cost me to suffer a giant failure in the beginning of my investment career.**

WHY I DON'T LIKE THE CONVENTIONAL DEFINITION FOR "MILLIONAIRE"

Let's suppose that Joe inherits a Rembrandt painting worth $1,000,000 dollars and it is hanging on his living room wall. The rest of Joe's assets minus his liabilities are $0. By definition, Joe is a millionaire. However, has the painting really increased the lifestyle of Joe? Other than being able to admire it, Joe's lifestyle has not changed.

Now suppose Joe takes the painting and sells it for $1,000,000 cash. Is Joe still a millionaire? The answer is "yes."

Next let's say Joe takes $50,000 of the cash and pays for a cruise around the world for a year. Is Joe still a millionaire? The answer of course is "no". If fact, if Joe took $50,000 each year out of the cash, he may have a lot of fun but he would eventually end up with $0.

Let's say that instead of taking the cruise, Joe invests the $1,000,000 into an asset that produces a yield of 10% every year. At the end of the year, Joe will have his million dollar asset plus $100,000 extra from the return on the investment. Now suppose Joe takes a cruise around the world twice that costs $100,000. Is Joe still a millionaire? Yes! Joe is not living off the original $1,000,000. He is living off the cash flow created by the $1,000,000. How long could Joe spend a $100,000 per year and still be a millionaire. The answer would be "forever."

Here is the definition of a millionaire that I prefer.

Millionaire – a person who has enough assets, no matter what their value, to create a residual income of at least $100,000 per year.

Example: Pete owns several rental properties. His equity (net worth) in the properties is $750,000. The properties create a cash flow of $100,000 per year. Is Pete a millionaire? By my definition, he would be.

When I first started purchasing residential income property in 1976, I was looking at the model of the **10th Multiple** and trying to acquire properties as fast as I could. Because of inflation, my properties were appreciating quickly. Every few months I would assign a value to my properties and then subtract the loan balances and see what my net worth was. In the beginning of 1986 I owned 100 units and if I was optimistic with my values, I could claim that my net worth was $1,000,000. By the conventional definition, **I was a millionaire.**

But I had negative cash flow. By my definition I had no net worth. I will explain what happened with my portfolio of 100 units a little later in this book.

HOW DO YOU WIN THE GAME OF MONEY WITH NET WORTH ASSETS?

The theory of investing in new worth assets is that you consistently put money into some kind of fund from which you buy assets, and supposedly these funds will grow in value due to appreciation and when you are done, your assets will be worth a large amount. When you retire, you will periodically sell off the assets for cash to live on until you die. The government has tried to help people invest for the future by deferring taxes on the income they are investing if they follow certain rules. Vehicles such as IRA's, Keogh Plans, 401ks, are examples of these plans. Most of the people that use these plans choose stock market products to fund them.

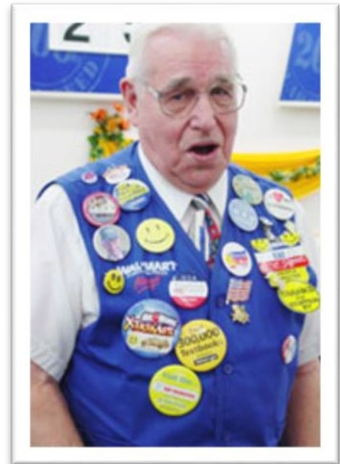
We see lots of advertisements on TV, radio, and in magazines trying to get people to go to a "financial planner" to put together an investment plan for retirement (Win the Game of Money).

Let's suppose that you called one of these financial planners and he gathered all kinds of information about you and your goals. You tell him that you want to retire at age 65 and live on an income of $50,000 per year. How much net worth would you have to acquire between now and age 65 for you to be able to reach that goal? $500,000? $1,000,000? More?

Let's hypothesize that you come up with the number $1,000,000 and on your sixty-fifth birthday, you look at your statement and it says your net worth has reached that number.

Now, let's do a little more hypothesizing. Let's say that your net worth does not increase or decrease from this point on. Let's also say that you don't have to pay taxes on your income and that there is no inflation from that point on. Pretty wild suppositions, huh?

We know that if you spend $50,000 per year, your $1,000,000 will last 20 years. If you die before age 85, you will have enough to live on. But what happens if you wake up on our 85th birthday and you are still breathing. Do you get out of bed and run down to Wal-Mart or McDonald's and fill out an application? Do you move in with the kids?



You really didn't Win the Game of Money and become financially independent because **your plan did not allow for you to live the rest of your life on your assets. Your assets died before you did.**

To Win the Game of Money with net worth assets, you have to have enough but in most cases you don't know how much is enough. Better plan on living to 120 to be on the safe side.

Now based on our example, let's suppose you die on your 85th birthday. What is left in your estate to leave behind to your children, charity or church? That's right, $0. You have no net worth left.

Let's look at another scenario. Suppose that instead of investing in net worth assets, you instead invest in cash flow assets like residential income property. Your goal is again to own enough assets to produce a cash flow of $50,000 per year starting at age 65 and you now have that cash flow from your property. Again we will say that the asset, our real estate holdings, do not go up in value when we retire, we don't have to pay taxes on our income and there is no inflation from that point on.

You start collecting your $50,000 per year cash flow from your rental income and you wake up on your 85th birthday. Do you have to go out and look for a job or move in with the kids? No! The income will keep coming in when you are 95 and 105.

When you die, what do you have left in your estate? Your real estate portfolio producing $50,000 per year with a large net worth that you can will to your kids, charity, or church and really make a difference for them.

We see wealthy people both in the past and present that set up trusts so that when they die, there assets are used to help charities or colleges. In my opinion, the best way to do this is to use the interest or cash flow generated each year by the assets and don't sell the assets so that the income is limitless.

WHAT I LEARNED FROM INVESTING AS A SPECULATOR

I started purchasing residential income property in 1976. Having reviewed several cassette programs and books on success, I set some personal goals. My first goal was to become $1,000,000 in debt. (Control at least one million dollars of real estate.) My second goal was to own 100 rental units. My third goal was to become a millionaire, have a net worth of at least $1,000,000.

In 1986, I reached those goals. I was well over $1,000,000 in debt and I owned 100 rental units, 53 were individually owned and 47 were owned with partners. (I will explain about the use of partners later.)

Because of the appreciation each year due to inflation, if I was generous with my property values, I could even claim a net worth of a million dollars. I was also highly leveraged in my properties (high loan to values) which compounded and increased by yield significantly. I thought I was doing great.

There was one problem. All my properties had negative cash flow.

This was mainly caused by the interest rates at the time being in the 10 – 12%+ area. Now, I had a couple of justifications for my optimism at the time even though I had the negative cash flow.

1. Each month that I paid my personal income into my management account for the negative cash flow, it was like a forced savings account. Instead of putting money in a mutual fund or a money market account and hoping my net worth would grow over the years, I was putting money into the paying down of a mortgage and in 30 years, the property would be free and clear and I could then live off the cash flow from the properties or sell them and live off the cash proceeds of the sale. That makes sense doesn't it?
2. I was also getting a tremendous tax loss due to the negative cash flow and favorable depreciation on my properties. Therefore I wasn't paying any income tax to the government. I rationalized that I was paying the bank with my money, building equity in my properties, instead of paying the government which was not going to be refunded to me down the line.

There were a lot of high income professionals that had the same philosophy as I did using reason #2. They would buy a property, regardless if it had a high negative cash flow because the tax benefits would be greater than the cost of the negative cash flow. They will still making a positive yield.

There are a lot of investors that enter the market with this philosophy even today. Is this enough justification to invest in real estate? **What do you think?**

Then something interesting happened in 1986. In its wisdom, Congress decided to pass a new tax law called **The Tax Reform Act of 1986**. Several positive things were done to reduce taxes for individuals and corporations but there were two changes pertaining to real estate that were devastating.

1) The depreciation laws were changed so that it took a longer period of time to realize the depreciation on a property and the loss each year was reduced.
2) The capital gains tax was changed to make it more expensive to sell a property.

Now, what do you think happened to the demand for investment property when a new buyer knew he had less tax advantages both as an owner and as a seller? The value of the property came crashing down. (Similar to the housing crisis we had a couple of years ago but for a different reason.)

Next, because of the loss of such important benefits, a lot of investors let their properties go into foreclosure and become repossessed mainly by Savings and Loan Companies.

As the number of properties foreclosed on increased, the Savings and Loan companies starting failing causing the **Savings and Loan Crisis**. The government created an entity, the **Resolution Trust Corporation (RTC)** to liquidate the assets held by the failing S&Ls. In all 714 S&Ls failed with the ultimate cost of $160.1 billion, about $124.6 billion of which was directly paid for by the US government via a financial bailout under the leadership of George H.W. Bush—that is, the US taxpayer provided the funding for the bailout, either directly or through charges on their savings and loan accounts and increased taxes—which contributed to the large budget deficits of the early 1990s. Kind of sound familiar to our last financial crisis! Who really caused these crisis to happen?

THE GOVERNMENT!

I was in the same situation. All my properties went from positive equity to negative equity. It no longer made sense to try to keep the properties. But I wasn't smart enough to understand the situation. I didn't want to lose what I had spent 10 years acquiring. I went to the Credit Union and borrowed $10,000 on a personal loan and I started feeding the property even more. Eventually I ran out of the $10,000 and the writing was on the wall. I had three options:

1. Try to sell whatever properties I could just to get out of the property. Forget about netting a profit. I was able to accomplish this with a few properties.
2. Some of the properties had 2nd trust deeds on them from sellers that I knew and I offered to just deed the property back to them and they agreed.
3. I let some of the properties go into foreclosure which of course negatively affected my credit for the next several years.

In 1986, I went from owning 100 units to owning one property with 5 units. I had that property in escrow twice but I couldn't get it to close. Finally, I gave up and paid my partner a couple of thousand dollars just to deed it to me and stop the bleeding for him.

After losing all these properties, I still had to pay the credit union back the $10,000. I also triggered some additional taxes that I had to pay. I went to a bankruptcy attorney but after listening to him, I decided to suck it up and pay my obligations, even though it hurt.

The moral of this story is that you, as an investor, need to know what is going on in all the areas that can negatively and positively affect the ownership of property and take actions if you need to before it is too late. By the way, I still own that 5-plex and will relate a few more stories about it later.

Now, you might think, after this story, the heck with investing in real estate. That is not your cup of tea. I felt that way for several years. I licked my wounds for 7 years before some things happened that got me back into the market.

So what did I learn from this experience.

First, it is utmost importance to watch for signals that will have a positive or negative effect of real estate investing.

Second, if a property starts to bleed, get rid of it quickly and cut your losses. Never use personal income or borrow money to feed a property that is going down the tube any way.

Later on, I will tell you a positive story that transpired because I now knew what to look for to guard against negative fluctuation and take advantage of positive gains.

CONCLUSION: THE BIGGEST LESSON THAT ILEARNED WAS NOT TO BUY REAL ESTATE AS A NET WORTH ASSET.

THE ONLY REASON TO PURCHASE REAL ESTATE ISAS A CASH FLOW ASSET.

"The moment a person begins to search for cash flow, they begin to find that most investments are bad investments." – Rich Dad

YOU NEED TO KNOW MORE THAN JUST THE PRINCIPLES OF INVESTING IN REAL ESTATE

In this book, I will teach you how to purchase real estate that is a cash flow asset. However, as I have mentioned, there are many outside influences, policies, and laws that have a direct impact of the value and cash flow of residential income property and these policies and laws are constantly changing. To protect yourself, you have to be aware of things that are going to affect your property both positively and negatively.

Example: One of the major influences on value and cash flow is interest rates. For the most part, if interest rates are low, property is worth more than when interest rates are high. As an investor, not only do you need to know what the current rates are, but you need to know what forces cause changes in interest rates and anticipate the trends.

Example: Lending policies are very important. Not only interest rates but loan-to-values and ease of qualifying also have a big effect on values. In the early 2000s, if you were breathing, you could get a loan. This is what caused our latest financial crisis where prices went up drastically for a few years before crashing down when the bubble burst.

Example: Another major influence on value is tax laws. Congress, depending on which party is in power, is constantly changing both depreciation laws and capital gains laws to either raise or lower taxes. Negative changes cause negative results. If I had acted quickly when the Congress was discussing passing the Tax Reform Act of 1986, I might have sold all my property for a profit and at least salvaged something for my 10 years of effort.

Example: The economy has an effect. This can have different results in different areas of the country. When the economy is poor, vacancy factors may be higher and rents sometimes have to be reduced.

Example: Inflation rates have a great influence both positively and negatively. High inflation means high appreciation. It usually also means high interest rates. The government usually raises interest rates to try to reduce the inflation rate.

CHAPTER 4
THE ART AND BILL MODEL

Over the years, I have spent many hours analyzing residential income properties and trying to come up with a simple method to determine an effective way to measure if a property is a good deal or not, based on the cash flow it generates. Cash flow is only one of the four yields rental property produce and your goal should be to have both positive cash flow and high yield. The best way to do this is to use what Robert Kiyosaki calls the second most powerful financial term - **LEVERAGE.**

I would now like to explain what I call the Art and Bill Model.

Art is a multi-billionaire. He is a friend of mine and I will introduce you to him. Art likes you and he makes you an offer. Art will lend you as much money as you want to borrow at 8% interest. The loan will be a personal loan and you will have to make monthly interest only payments, starting 30 days after he givesyou the money.

So the question is: "How much money do you want to borrow from Art?

$1000? $10,000? $100,000? $ 1,000,000? More?

Remember, you have you first payment due in 30 days. What are you going to do with the money?

Well, what number did you come up with? This was always an interesting part of my live seminars. I had people who didn't want to borrow any money to others who said "millions of dollars."

What did you decide to do with the money that you did borrow? Most attendees would say they would buy real restate. Could they do it and afford the 8% interest? This is an interesting question!

Let me tell you an option that I have for you.

I will introduce you to another friend of mine named Bill. Bill is the world's safest borrower. He always pays his debts.

Bill is looking to borrow money at this time and he is willing to pay 12% interest on the money that he borrows. He will make monthly payments of interest only, with the first payment due 30 days after he receives the money.

Now the question becomes: "How much money do you want to borrow from Art and loan to Bill?"

If you understand what is happening, your answer should be: "As much as Art will loan me!" Why? Because you are making 4% interest on every dollar you loan to Bill. If you had borrowed $1,000,000 from Art and loaned it to Bill, you would make $40,000 per year. You are making money on borrowed money!

So what is your yield on this transaction? How much of your own capital do you have invested? The answer is that you have none of your own money invested and the yield would be determined by dividing the $40,000 profit by zero. Now if you remember your basic math skills, you know that you cannot divide by zero. Actually your yield would be infinite.

Let's take some time next to discuss how money is made today in our society.

Leverage is primarily the use of OPM (Other People's Money) and OPT (Other People's Time). In trying to understand how leverage is used to make money, I want us to spend a few minutes looking at the 3 biggest business entities in the United States – Banks, Corporations, and Insurance Companies.

How do banks make money? Banks are in the business of loaning money. When they make a loan, they charge interest and this interest is their gross income. But where do banks get the money to loan. One of the primary sources is individuals that put their money in the bank for safety and to earn interest themselves. Now is the interest rate the same for the depositors as it is for the creditors? Of course not! The margin between the interest given and the interest received can be very high. Just look at the interest rate charged on credit cards! What model are the banks applying? There are borrowing money for a low interest rate and turning around and loaning it at a higher interest rate. This is the classic example of **THE ART AND BILL MODEL**!

Next, let's look at corporations. They are a little different. One way they make money is to create and sell stock in the company. By doing this they raise capital to create a product or service. They purchase land and equipment and hire employees to manufacture their products or provide their services for a profit. With this profit, they may pay the stock holders a dividend or they may not. But the process is to borrow money from people, and use it to make a profit.

Lastly, let's look at insurance companies. They are in the business of protecting people from loss. They charge premiums to their customers and they take this money and do two things with it. They put some of it away for claims and they invest the rest. Insurance companies are one of the biggest investors in the world. They make a higher return on their money than what they have to pay.

As you can see, all three of these entities are using the Art and Bill Model to earn money. They are all using OPM to leverage their returns.

TWO TYPES OF LEVERAGE

Next, I would like to continue discussing the power of leverage used two different ways. The first type of leverage I learned about early in my investment career. Let me give you an example:

Example: You purchase a triplex for $100,000 and pay all cash. The first year that you own the property, it appreciates $5,000. What is your yield from appreciation?

$$\$5{,}000 \div \$100{,}000 = .05 = 5\%$$

You purchase the same triplex with a down payment of $20,000 and a new loan for $80,000. It appreciates $5,000. What is your yield from appreciation?

$$\$5{,}000 \div \$20{,}000 = .25 = 25\%$$

In this example you can see that leverage increased the yield by a multiple of 5. Pretty good return?

But what is your return if the property does not appreciate at all? In both cases it is 0%! In this example, we are looking at the property from the view as a speculator and as a net worth asset.

The second type of leverage involves the application of the Art and Bill Model.

Example: You purchase the triplex for $100,000 with $20,000 down. There is no appreciation. The cap rate (rate of return if you owned it free and clear) on the triplex is 11%. The loan of $80,000 is amortized over 30 years at an interest rate of 7%. What is your yield?

The cap rate of 11% means that for a property worth $100,000 your net operating income is $11,000.

$100,000 X .11 = $11,000

The amount of interest you will pay on the loan for one year is $5574. Your net cash flow and debt reduction is $5426. Your yield would be

$5426 ÷ $20,000 = .27 = 27%

27% yield with no appreciation is pretty exciting.

You are now looking at the property as an investor purchasing real estate as a cash flow asset.

Remember the Rule of 72. How long would it take to double your money in 3 years?

72 ÷ 3 = 24%

Now what happens if you do get both cash flow and appreciation? In this example, with 5% appreciation your first year your yield would be:

$5000 + $5426 = $10,426 ÷ $20,000 = .52 = 52%

If I purchased this property as a speculator and the property does not appreciate, I am pretty unhappy. If I purchased this property as an investor and the property does not appreciate, I am very happy with my yield.

BUY PROPERTY USING THE ART AND BILL MODEL FOR MAXIMUM RETURN AND MINIMUM RISK.

THE THEORY OF CHEAP MONEY ORHOW YOUR BENEFIT FROM INFLATION FROM YOUR LENDER

One of the first things any investor needs to learn about is inflation. Inflation can have a significant positive or negative effect on investments. You can take advantage of inflation or inflation can take advantage of you.

According to Wikipedia, in economics, **inflation** is a rise in the general level of prices of goods and services in an economy over a period of time. When the price level rises, each unit of currency buys fewer goods and services. Consequently, inflation is the destruction of the purchasing power of money – a loss of real value in the internal medium of exchange and unit of account in the economy.

The consensus view of economists is that a long sustained period of inflation is caused by money supply growing faster than the rate of economic growth. (Gee, is that happening today in the United States? What is our projected deficit for this year? Will we see some high inflation soon?)

Over the years, real estate has had a tendency to rise in value. The main reason for this is inflation. **Real estate is a hedge against inflation.** You can have short term appreciation from supply and demand.

In most cases, I have not been negatively affected by inflation. One way that I look at inflation has to do with the cost of an item based on number of hours a person has to work to pay for that item.

Example: In 1980, it took a person 24 hours of work to pay for a refrigerator. If it takes the same amount of hours in 2010 to purchase a refrigerator, then the person is essentially even. Because of technology and an international market, some items even cost less to purchase than 20 years ago.

If a person's income rises at the same rate as inflation, theoretically he should stay even. If over a 10 year period, a person's salary goes up 30% and the inflation rate is 30%, they should be breaking even. However, there is one big problem with this theory. As you make more money, the government wants a **larger percentage** of your salary. They win during inflationary times.

I heard about the **Theory of Cheap Money** early in my investing career and it makes more sense when we have high inflation.

When you go to the bank or savings and loan and take out a thirty-year-loan, based on your loan amount and your interest rate, you monthly payment amount can be determined.

Example: On January 1, 2010, you borrow $100,000 at 7% fixed interest for 30 years. Your payment will be $665.30 every month for 30 years. The last payment in January, 2040 will still be $665.30. Over the 30 year period of time, what do you think the chances are that the United States will experience some inflation? If you believe the chances are pretty positive, you will also see that because of inflation, the U.S. dollar will deflate in value. Inflation will normally allow you to charge more money for rent over the years to counter inflation. **As the years pass, the value of the payment you are making to the bank is going down because of the loss of purchasing power of the dollar.**

If you go to the website **http://www.usinflationcalculator.com**, there is an INFLATION CALCULATOR. It measures the buying power of the dollar over time.

If we had made our loan in the example above in 1980, this is what would have happened over a 30- year period of time.

Payment amount $665.30.

At the end of the first 10 years, $665.30 would only be worth $389.52 in buying power, and the rate of inflation change would have been **- 41.5%.**

During the next 10 years, the $665.30 would have shrunk to $289.92, and the rate of inflation change would have been **- 56.4%.**

For the last 10 years, the payment would have shrunk to the equivalent of $223.65 because of the inflation change of **– 66.4%.**

You can see that in real dollars, this loan would have cost two-thirds less to the borrower during the last 10 years.

This is one of the reasons that lenders started offering and in some cases requiring adjustable rate loans on properties. To try to counter changes in inflation rates and interest rates.

This is also a reason most "savers" lose money when they give it to the banks or purchase government investments and other low interest vehicles.

Our government wants to take advantage of inflation also using this same process. When they borrow money from individuals and countries by issuing Treasury bills (T-bills), Treasury notes (T-notes) and Treasury bonds (T-bonds), their goal is to pay off these loans with devaluated dollars.

CHAPTER 5
OTHER TYPES OF ASSETS

There is only so much investment money out in the market. Most investors are looking to find the best asset to invest in. In some cases, the asset they feel is the best is really not the best asset available. (Belief Window)

Back in 1975, I took a college course on the stock market. Of course computers weren't as sophisticated as they are today. There was a discussion about a contest that was performed. First, several of the top stock brokers where contacted and asked to do an experiment by starting with a fixed amount of money, picking stocks to pretend to invest the money in, and after a period of time, seeing what yield each of brokers produced. At the same time, they pinned a list of all the available stocks on a wall and had a monkey throw a dart at it. Where the dart hit, those stocks were used in the same experiment. At the end of the experiment, **the monkey won**.

Of course, one of real estate's main competitors for investment capital is the stock market. I could never understand why the stock market is attractive to the average person other than they do a lot of advertising and it is easy for an individual to give his money to someone and then not think about it much. Of course, I have tried to teach you that most people who invest in the stock market are **speculators, not investors.**

I remember that in 1998 and 1999 the real estate investment market really sucked. At one time I had 55 listings, which was 22% of all the rental properties for sale in my market. There were a lot of motivated sellers and most of these properties were really great investments which would provide a high yield. However, a real estate agent doesn't make money listing property. He makes money when the listing is sold and closes escrow.

Well, what was going on at the time? The stock market was going berserk. It was crazy. This was the time of the "high tech" era. On March 10, 2000, the NASDAQ was at an all-time high of 5048. There was massive demand.

I had to do something to find some buyers and make them aware of the great opportunities in my market. I decided to create my first seminar to be presented to the public, a free two-hour seminar entitled – **HOW TO BUILD A REAL ESTATE MONEY MACHINE**.

Well, I got a few people to come to the seminar and they could see that the timing was great to buy real estate and in 2000 I had my best year ever selling over $15,000,000 in property. I also purchased several properties for myself.

I tell people that the time to buy any asset is when other people are not excited about that market, not when everyone is buying. Look at what everyone else is doing and then do the opposite. **Become a CONTRAIAN.**

Do you notice when the GURUS come out of the woodwork and start peddling their wears? Is it when the market is down and real slow or is it when the market has become red hot and the trend is almost over?

STOCKS AND MUTUAL FUNDS AS AN ASSET

We have talked about cash flow assets and net worth assets. I want to spend a little time on the stock market. When I mention stock, I want to include mutual funds because they are a package of stocks. The stock market is an international market. You can buy stocks in foreign markets and foreigners can purchase stocks in the U.S. market. Just about all stocks are net worth assets. There are some stocks that pay out dividends but these have been decreasing in number. Remember, a person who purchases an asset with the hope of it going up in value is a speculator.

When you purchase some shares of stock, you own a very small part of a company. You have no control of the company. There is nothing that you can do to make the stock go up.

For the most part, you have no leverage in the stock market without a large amount of risk. Therefore is hard to compound your yield.

THE NEW YORK STOCK EXCHANGE **NASDA**

By the way, on March 12, 2001, shareholders lost $554 billion on all exchanges.

According to the Fed, Americans lost 16 trillion dollars of net worth during the that recession

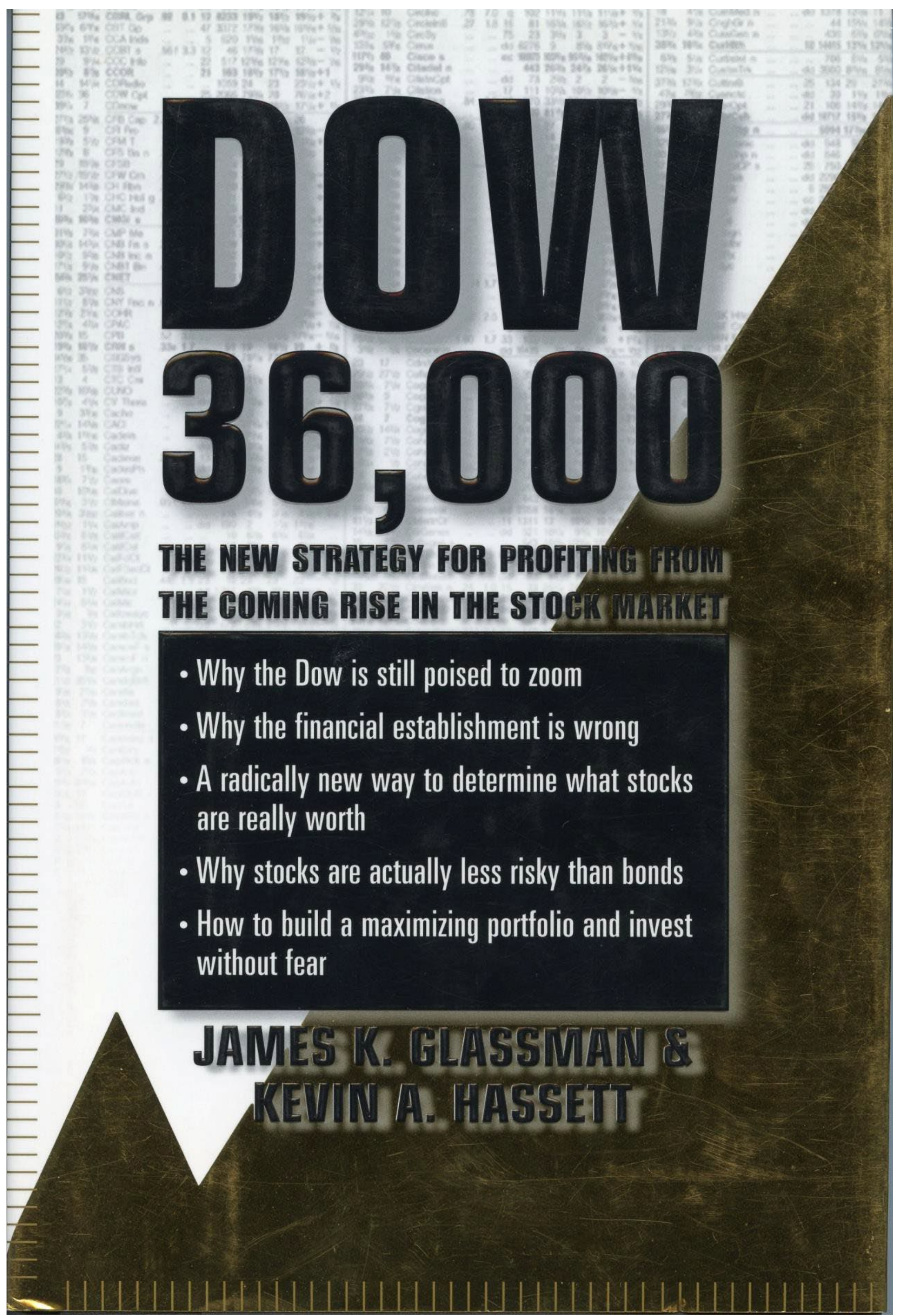
THE STOCK MARKET "MARKET"

As I have mentioned, the stock market is an international market that uses large corporations to sell individual stocks, mutual funds, and other paper products. These corporations make billions of dollars every year and the competition is very strong. If you walk into a Barnes and Noble or Borders book store, go to the magazine and newspaper area and you will see a lot of daily and weekly published periodicals dedicated almost completely to the stock market.

In these periodicals you will find large full page ads from the large trading companies.

When you listen to the radio or watch TV, there are constant updates on the different stock market measuring groups. There are even whole shows dedicated to discussing the market also sponsored by the stock brokerage firms.

THEY DO AN EXCELLENT JOB MARKETING THEIR PRODUCTS TO THE PUBLIC, BOTHNATIONALLY AND INTERNATIONALLY.



Here is a book copyrighted in 1999 by a couple of stock market gurus predicting the DOW would hit 36,000. I'm glad I didn't listen to their expert advice on how to make my fortune in the stock market. As of August 2021, it still has not hit 36,000!

PURCHASING GOLD AS AN INVESTMENT

It has been very interesting over the years to watch the advertising for different types of investments.

As I write this section of the book, it seems like 50% of the advertisements on the news channels are sponsored by companies telling you what a great investment gold is at this time. Gold is currently trading around $1200 per ounce. One of the ads states “that many experts are predicting gold to climb to $2000 per ounce or even $5000 per ounce.”

One of the great lessons that Robert Kiyosaki teaches is:

“Never buy investments from poor people or sales people.”

Unlike most other assets, the company that sells the gold owns the gold. There is not a broker or agent representing a seller and a buyer. The owner is selling their product directly to a buyer. The question that I have is why would they tell a buyer that gold could climb 100% to 500% in the next few years, and then turn around and sell their inventory? Why would they take a small commission at this time instead of holding and taking advantage of the appreciation that is coming?

Here is a part of a full page ad that was in the October 11, 2010 USA Today newspaper. You can see that it is really relying on the greed of speculators. Gold going up 11 times what it is selling for now really sounds good. I can’t wait to call them as soon as I am done with this page. By the way, this company is not a member of the Better Business Bureau, has a C- rating with 37 complaints in 36 months.

Is gold a net worth asset or a cash flow asset?

OTHER COLLECTIBLES

There are tons of things that a person can buy and then try to sell for a profit. Just take a look at eBay. The problem is all of the items are based on net worth assets. Even if you sell a lot of items for a profit for a period of time, as soon as you stop, your income stops. There is no passive income created with this model.

COMPARING YIELDS WHEN THE MARKET GOES UP AND WHEN THE MARKET GOES DOWN

Next I would like to share some ideas that I learned from a friend of mine who sells insurance and also invests in real estate. One day I was at his office and the stock market came up in our discussion. He had a report that was published by one of the stock brokerage firms that showed the yield that a person would get over the years if they just bought stock on a consistent basis and didn'tsell. ***Another name for this is income averaging.*** If I remember correctly, the average was around 12%, which would be a pretty good return.

Next he asked me this question, "If you purchase $1000 worth of stock or mutual funds and over time they go up 50% and then they go down 40%, what would be your yield?" Well, being an ex-math teacher, I answered positive 10%. Does that sound right to you? Let's do the math.

$1000 increased by 50% gives us $1500.
$1500 decreased by 40% gives us $900.

The net effect is that we actually lost $100 or a **10% loss of our initial investment.**

Now that doesn't sound right to me. Does it to you? Let's reverse the situation where we purchase $1000 worth of stock or mutual funds and over time they go down 40% then up 50%. That should give us a positive 10%, correct? Let's do the math again.

$1000 decreased by 40% equals $600.
$600 increased by 50% equals $900.

We **still lose $100 or 10% of our initial investment.** What does this show? It illustrates that if an asset goes down a certain percentage, it has to go up a higher percentage to get back to even.

Let's look at this in a real case situation. Let's take the Dow Jones Industrial Average. On October 9, 2007, the all-time high was reached of 14,164. On February 27, 2009, the Dow closed at 7062 a loss of 7102 points or **50.1%**. On January 16, 2010, the Dow is at 10610, a gain of 3548 since the all-time low. This is a gain of **50.2 %** which is almost exactly the same percentage as the loss. And yet his still has to gain another 3554 points to get back to the high.

So what yield will the Dow have to get for it to get back to its all-time high from the 2009 low? **The answer is a 100.6% gain.**

Let's also look at the NASDAQ while we are comparing numbers. On March 10, 2000 it closed at its all-time high of 5048. On October 10, 2002 it bottomed out at 1108. This was a loss of 3940 points, or **78.1%**. On January 16, 2010 the NASDAQ closed at 2288, a gain of **106%** from the low but it is still 2760 points from the all-time high. **To reach its all-time high from the bottom, NASDAQ will have to gain 356% which is a little different than the 78.1% loss.**

LET'S LOOK AT SOMETHING INTERESTING

Let's say you receive an inheritance of $20,000 that you want to invest. Your brother is one of the top stock market gurus in the country and he has determined after much research that the stock for Wells Fargo Bank will double in the next year. He shares this information with you. Next, you meet with your brother-in-law, who is the head loan officer for the local Wells Fargo Bank. You have been using this bank for years and have obtained several loans which you have always paid back on time. Your credit score is almost 800. You have some personal debt on a new boat and RV that you purchased so you really don't have any discretionary income to make payments on another loan. You tell your brother-in-law that you want to borrow $80,000 from the bank and add your $20,000 to purchase $100,000 of Wells Fargo stock. You want him to secure the $80,000 loan on the stock. What do you think your brother-in-law will tell you?

He will tell you that he can't secure the loan with stock. Next, he will tell you that normally he could secure the loan on some other kind of collateral, such as equity in your home but you can't qualify because your payments are too high compared to your income.

I'm not aware of banks and savings and loans making loans for people to purchase stock. Are you?

Let's look at another scenario. You have an uncle who is a real estate broker that specializes in residential income property. You uncle shows you a triplex currently for sale for $100,000 that is in good condition and has established tenants that pay a good rental income. The expenses are very reasonable and with a $20,000 down payment, the property will pay all of its expenses with a $200 per month cash flow. You now go back to your brother-in-law and tell him you want to get an $80,000 loan on the triplex. What do you think your brother-in-law will tell you?

Most likely, he will pull out an application and get you started on the loan right away. Why?

Banks make loans on real estate every day. They know that it is a tangible asset, not just a piece of paper. Also, they understand that the property will make the loan payments, not you personally.

So if banks are excited about making loans on real estate and not on stock, does that tell you anything?

"Why don't more people invest in real estate? Because to invest in real estate, you have to be a better investor. Investing successfully in real estate not only requires more financial skills, investing in real estate is much more capital-intensive and management-intensive. Getting into paper assets such as mutual funds is much easier, less expensive, and requires very little management, which is why so many more people invest in them" – Rich Dad

ANOTHER INTERESTING COMPARISON BETWEEN CASH FLOW ASSETS AND NET WORTH ASSETS

If you purchase net worth assets, it will be harder to create additional cash to purchase more assets. First, you are receiving no cash flow to apply to new investments. Also, it is difficult to borrow money from a bank secured on a net worth asset. The only way to purchase more assets is to save money out of your personal income.

Example: You purchase 1000 shares of stock at $10/share for $10,000. Over a period of time, the stock doubles in value to $20,000. What can you do to use this increase in value to buy more stock?

When you purchase a cash flow asset, something is different. If you purchase a $100,000 property with $20,000 down, the cash flow from the property and the tax savings from the government are actually placed in your pocket. Over the years, there is a good chance that these two cash flows will accumulate to equal your down payment. This means that you are now controlling your property with none of your original capital investment. You are now free to use that money to purchase more assets.

Also, as the loan payments are applied to the loan balance of the property is reduced you're your equity increases. Also if the property appreciates your equity grows. As time passes, there are ways that you can pull out some of that equity, both conventionally and creatively to also use to purchase more property.

Example: You purchase 756 Adams Street, a $100,000 property with $20,000 down. You finance the property with an $80,000 first trust deed, 6% interest, amortized over 30 years. The cash flow from the property is $2400 per year. The tax benefits add an additional $200 per year. You would have your original down payment returned to you in 8 years.

Example: Over the years, the Adams Street property appreciates 5% per year. After 7 years, the property would now be worth $140,700. You go to the bank and refinance the property with a 75% loan to value. The bank gives you a new loan of $105,500. From escrow, you receive a check for $33,800 which includes your $20,000 down payment plus an additional $13,800 of your equity from appreciation and debt reduction. You can go and purchase other property with these

Example: Using the above example, instead of going to a bank and getting a new loan, we make an offer on another property offering the seller a note and trust deed for $30,000 secured on Adams Street as all or part of the down payment.

CHAPTER 6
REAL ESTATE BASICS
REAL ESTATE DEFINITIONS

Annual Property Operating Data Form (APOD) - a form used to analyze the yield of a residential income property or other investment property

Appreciation – When a property or asset goes up in value either by improving the property, supply and demand, or inflation.

Amortization – Payment of principal and interest at stated periods for a stated time until the debt is extinguished.

Buyer's Market – In real estate, when more properties are for sale that there are interested buyers.

Capital Gain – That profit on the sale of an asset held for a certain length of time that is subject to taxation.

***Cap Rate** – The rate of return on a property if you owned it free and clear. **(Net Operating Income divided by the Value of the Property.)**

Cash Flow – Your net income after all expenses are subtracted from your gross income.

Cash – On – Cash – The amount of cash received compared to the amount of cash invested.

Depreciation – A term applied to an improved asset that says that the economic life is only so long and after that it has no value. The IRS currently allows you to depreciate the improvements of a residential income property over 27.5 years no matter the age of the property.

Debt Reduction – The amount of principal reduction on an amortizing loan over a period of time.

Tenant Estoppel Certificate - a declaration, signed by the Tenant, to check that the tenant and the seller agree as to the rent amount, any prepaid rent, amount of tenant deposit, and back rent owed if any.

Gross Rent Multiplier – a number that you get when you divide the sales price by the gross yearly rental income. **The lower the GRM, the better.**

Leverage – The use of financing or other people's money (OPM) to control a piece of real property with a small amount of your own invested capital.

Loan to Value (LTV) – the percentage that you get when you divide the loan amount by the purchase price.

***Net Operating Income** – The income that is left after you subtract all of the expenses on the property except loan payments.

Pre-tax Cash Flow – Cash flow before taking into effect the tax consequences of owning the property.

Post-tax Cash Flow – Cash flow after taking into effect the tax consequences of owning the property.

Seller's Market – In real estate, when there are more interested buyers than available properties.

Vacancy Factor – The yearly percentage or estimated percentage of vacancies and lost rental income in a rental project.

We will go into more detail explaining these terms and giving examples later on in our book.

TYPES OF BUYERS

Let's say you are talking with a real estate agent and he says there are 375 residential income properties on the market in your area, anything from a duplex to a multi-plex. Some of these properties are priced right and have good cash flow. Some have motivated sellers trying to cut their losses. Some have owners who are just throwing their property on the market to see if they can find someone who will pay more that the property is worth. Most of these owners want some security when they sell. They do not want any potential negative consequences to happen if possible.

There are four financial positions that you as a buyer can be in:

1. You have cash for a down payment and can qualify for a loan. This means that you can pretty much purchase any of the 375 properties on the market.
2. You have cash but cannot qualify for a loan. There will be some properties that a smart creative agent will be able to help you purchase.
3. You have no cash but can qualify for a loan. You are very limited in the number of properties that you will be able to purchase.
4. You have no cash and cannot qualify for a loan. Why would any owner with a good investment property want to sell to you? You are not a good risk. You have a very small chance of purchasing a property.

A FEW THINGS YOU SHOULD KNOWBEFORE YOU GET STARTED - RESIDENTIAL INCOME PROPERTY ETTIQUETTE

When an agent lists a client's home, he wants as many people to view the home as possible. He will expose the home with a big "For Sale" sign. He will have open houses and have his office's caravan stop and look inside the house. There will be a lock box on the house so that agents from other offices can show the property at their buyer's convenience.

A professional agent who lists a multi-family property knows that the value of an investment property is determined by the income it generates. This income cannot be endangered. They understand that they cannot parade every interested buyer and their brother-in-law through the units of a property for sale. This is disruptive to the tenants. By law, a tenant must be given at least a 24-hour notice in order for the owner or anyone else to enter unless there is an emergency like a fire or flood. In the listing, the agent should state that the buyer needs to make an offer "subject to interior inspection" and have the offer accepted before he can see inside the units.

An agent should never put a "for sale" sign on the property. I never had any "for sale" signs for my office. This is a giant red flag that may cause the tenants to get scared that their rent maybe going up and possibly cause them to move. For my listings, a tenant would not know the property was for sale until an offer had been presented and accepted by the owner.

You should be instructed by your agent that as you go out and look at properties that are for sale, look at the exterior of the units only until you have written an offer and it is accepted. **DO NOT EVER DISTURB TENANTS AND ASK THEM QUESTIONS. ABSOLUTELY NEVER GO UP TO A TENANT'S DOOR AND BANG ON IT AND ASK TO SEE INSIDE THE UNIT.** If you are walking around the outside of a unit and a tenant asks you what you are doing, just tell them you are looking around the area for an apartment to rent. **DO NOT TELL THEM THAT THE PROPERTY IS FOR SALE AND YOU ARE A PROSPECTIVE BUYER.**

You can get a feel for the interiors by looking at the condition of the exterior. If you decide to write an offer on a property, there should be a clause that states "This offer is subject to inspection and approval of the interior of the units by buyer within X days of acceptance of the offer."

WHAT DETERMINES THE VALUE OF A PROPERTY?

First of all let me tell you what the value of a property is <u>not</u>:

- What the seller says the value of the property is
- What the seller's real estate agent says the value of the property is
- How much the owner paid for the property
- What the tax assessor says the value of the property is

By definition, the fair market value of a property is the estimate of the market value of a property, based on what a knowledgeable, willing and unpressured buyer would probably pay to a knowledgeable, willing and unpressured seller in the real estate market.

That is a great definition but there are a lot of influences that become involved.

The first is the term **knowledgeable**. In the stock market or precious metal market, the prices are based on an international, minute by minute market. This market is influenced by supply and demand which is influenced by different measurements that are published on a regular basis. If you want to buy 20 shares of General Motors stock, you can call your stock broker or go on eTrade and the price is right there. There is no negotiation based on motivation. You can own the stock in just a few minutes.

Real estate is kind of like a long term auction on a unique product. There is a suggested bid price which is the asking price. If the property is overpriced there will be no demand. Since there is just an asking or list price, an unknowledgeable buyer who is represented by an unknowledgeable agent will probably pay more than the fair market value to a knowledgeable seller or agent.

Knowledgeable investors are looking for a return on their money. Not just any return, but a predetermined minimum return which would warrant the risk of their money for the reward they want to receive. This is what investing is all about.

In reality, the real estate market is just like any other market. It is governed by the law of supply and demand. When there is high supply and low demand, those owners that want to sell will have to take less. At times, the Art and Bill Model will look very good. This is when knowledgeable investors are in the market.

When there is low supply and high demand, the sellers can raise their prices and in most cases the Art and Bill Model is not in play. This is when you see the gurus pedaling their wares and speculators are listening to them.

WHAT CAUSES SUPPLY AND DEMAND?

Next, I would like to share some ideas with you on some of the trends that I have seen over the years that directly affect the residential income market supply and demand.

1) Other investment markets
2) Interest rates
3) Existing prices
4) Number of properties for sale
5) Tax laws
6) Availability of money
7) Marketing expertise of real estate agents
8) Cost of material and labor to build new inventory
9) Lending requirements
10) Recessions and booms
11) Foreign investors
12) Tenant laws
13) Rent control

Learn about these trends, learn how to measure them, and keep track of them.

WHEN SHOULD YOU BE EXCITED ABOUT BUYING RESIDENTIAL INCOME PROPERTY?

You might answer that question, “When prices are low,” or “When interest rates are low.”

And my response to your answer is “maybe.”

If you really understand what I am trying to teach you, you will have only one answer.

“When the difference between the cap rate and the interest rate is a nice large number.”

The time to buy is when you can apply the Art and Bill Model successfully. This is how you build a real estate money machine.

WHAT IS THE HIGHEST VALUE A PROPERTY WILL APPRECIATE TO?

Bakersfield, California is an interesting place to live and invest in. It lies in the southern area of the San Joaquin Valley, one of the largest agricultural areas in the world. Oil was also discovered in the area and there are oil wells all over the place. In fact, one of the suburbs of Bakersfield is called Oildale. The area is pretty flat and is mostly made up of farm land with some areas of desert type terrain. Through the 40 years that I lived in Bakersfield, there was a lot of growth in population. Land was relatively cheap and plentiful and so the cost of houses was relatively low compared to most of the rest of California.

Of course this growth occurred in spurts, depending on the economy and other positive and negative circumstances.

COST TO REPRODUCE THE PROPERTY

In 1997, I got married and decided to move out of a condo that I was renting and buy a fourplex to live in. (This was the first time that I used my “Live for Free” model explained later).

I looked at several pride of ownership properties and decided to buy one in the southwest area where I had lived most of the time I was in Bakersfield. The fourplex I purchased had a 3 bedroom, two bath master unit with fireplace and 2 car garage and about 1300 square feet. The other units were two bedroom 1 bath and about 900 square feet and they had 1 two-car and 2 one-car garages. It was like buying a nice home with 3 units attached. I purchased the property for $167,500.

The living area had 4079 square foot structure included 4 living rooms, 4 kitchens, 9 bedrooms, 5 baths, and a 6 car garage. I purchased the property for around $41 per square foot.

In the meantime, if I tried to find a single family house with 4000 square feet and 9 bedrooms, 5 baths, and 6 car garages, it would have cost me close to twice as much at the time.

Also at that time, there were some nice duplexes for sale with 2028 square feet, and 2 2-car garages. They were selling for around $108,000 in 1997, which is $53/ square foot. A house with that square footage would have cost at least 1 ½ times that.

What I am trying to show you is at certain times, you can purchase property for a lot less that the cost of reproduce it. It is at these times, that building slows way down because builders cannot build a property for the cost of existing properties.

The highest sales price an existing property will appreciate to is about what it would cost to build a new identical unit at that time.

The exception to this rule is when you have a very small amount of buildable lots available in an area. Then, because of the rarity of the properties, prices will be higher.

THE EFFECT OF AREA, NUMBER OF UNITS, AND CONDITION OF THE PROPERTY ON CAP RATE

What I am trying to do is put you in a position where is easier to evaluate the yields or separate properties so you can make comparisons.

When looking at these numbers, you should understand that such things as number of units, areas, and condition of the property all have a positive or negative effect on the cap rate. As part of your plan of action, you need to define how many units you want to purchase on one property, what is the quality of area you want to focus on (management intensive), and what physical condition of the property are you willing to accept.

Some general rules that you will see are:

- The higher the number of units, the higher the cap rate should be. The cap rate for a six-plex should be higher than a triplex in the same area and condition.
- The tougher the location of the property, the higher the cap rate should be. A fourplex in a bread-and-butter area should have a higher CAP RATE than a fourplex in a pride-of-ownership area.
- The rougher the condition of the property, the higher the cap rate should be. A triplex with a lot of deferred maintenance should have a higher cap rate than a well-maintained triplex next door.

WHAT IS THE BEST PROPERTY TO BUY – SINGLE FAMILY HOUSE, DUPLEX, TRIPLEX,FOURPLEX, 5 OR MORE UNITS?

Here is another question that I am asked frequently. Should I buy single family homes, duplexes, triplexes, fourplexes or 5 or more units? And my answer is, **"IT DEPENDS."**

There are lots of investors who like to purchase single family homes and do very well. Othe rinvestors like multi-family properties. Let me discuss some benefits and negatives that I have

BENEFITS TO PURCHASING SINGLE FAMILY HOMES

1. When it is time to sell, you will have more types of buyers. You can sell the property to either a person who wants to live in the property or an investor.
2. The tenant usually pays for all the utilities such as water, trash gardening, etc.
3. The financing is usually better for investors.
4. When you sell the house, you have a better chance of cashing out.
5. Single family dwelling are easier to lease for a long period of time.
6. The tenants are usually more stable.

NEGATIVES OF PURCHASING SINGLE FAMILY HOMES

1. You will be competing with buyers who want to purchase single family homes as their personal residences.
2. The ratio of rent you can charge compared to cost of sale is usually lower than the ratio for multi-family, especially as the price of the house goes up. This makes it harder to get a positive cash flow.
   Example: The gross rent from a $250,000 fourplex will be a lot higher than a $250,000 home.
3. Professional management usually charges more for a house than per unit for a multi-family property.
4. When you have a vacant house, you have a 100% vacancy rate.

BENEFITS OF PURCHASING DUPLEXES, TRIPLEXES, AND FOURPLEXES

1. The financing is better for investors than for 5+ units. The interest rates and the down payment required by a lender will be lower.
2. The ratio of the rent collected to the price of the property is usually better than single family homes.
3. Sometimes you can be more creative when financing multi-family units than single family homes.
4. When you have a vacant unit in a fourplex, you have a 25% vacancy rate.
5. It is easy to sell 2-4 units than 5+ units because a buyer can get better financing and usually the down payment is less.

NEGATIVES TO PURCHASING DUPLEXES, TRIPLEXES, AND FOURPLEXES

1. You will have more competition from buyers because they require less down payment and are easier to finance the 5+ units.

BENEFITS OF PURCHASING PROPERTIES WITH 5+ UNITS

1. Your cap rates will usually be higher as the number of units increases which increases your cash flow.
2. It is easier to manage a larger property than several smaller properties. You may even use a resident manager.

NEGATIVES OF PURCHASING 5+ UNITS

1. In most cases you will need more down payment and it is harder to find a loan for the property.
2. It will be harder to sell the property because there are fewer buyers.

A GENERAL RULE FOR COMPARING EXPENSES TO THE NUMBER OF UNITS.

In most cases, the greater the number of units a property has, the less the cost per unit for:

1. Taxes
2. Insurance
3. Water
4. Gardening

As I said at the beginning of this section, in determining the number of units a person should consider buying, a single family home up to a multi-plex, the answer is **"it depends!"**

I found that investing in single family homes involves focusing on a completely different market than multi-family properties. Personally, since I specialized in multi-family properties, I stayed away from single family investing.

My philosophy was that whether I was looking for property for my clients or for my own account, I always wanted a **"GOOD DEAL!"** I have owned some single family homes and I have owned a 21-unit complex. I currently own two houses on one lot, a house and duplex on one lot, 3 five-plex properties, a seven unit complex, and a 20-unit complex.

I mention throughout this book, the details on how I acquired some of my properties. In a lot of cases, it was the financial terms, not the number of units that made the purchase attractive

Even though I don't own one at this time, I think the absolute best property to buy for a beginning investor is a fourplex. For more seasoned investors, I would recommend them to purchase as large of a complex as they feel comfortable with. The more different properties that you own gives you a lot of flexibility when you either want to refinance, exchange, or sell a part of your portfolio.

WHEN YOU INVEST IN REAL ESTATE, YOU HAVE 3 LIMITED PARTNERS

Investing in real estate allows you to be the sole owner of a property. You become the general partner, the person in charge. You have the ability to make all the decisions regarding the running of the property: what you charge for rent, what improvements you want to make, when you want to sell or exchange.

But, you also have 3 limited partners that automatically come with the property that make great contributions to your success.

LIMITED PARTNER #1 – TENANTS

For the benefit of being able to use the property, the tenant pays a monthly fee or rent. This rent should pay all your expenses plus give you some extra cash flow. The tenant is actually paying off the property for you. Suppose a tenant stays in a unit for 5 years and pays $450 per month. They will be giving you $27,000 over the 5 years. When the tenant moves out, you will probably give them their security deposit back that you held for them. They make no profit on the property for the time that they lived there. Part of their rent went to your next limited partner.

LIMITED PARTNER #2 – BANKS OR LENDERS

For the benefit of loaning you money to purchase your property, the lender is paid interest by you. As I mentioned, these payments really come from the rents paid by the tenant. If the property appreciates in value, the lender does not participate in the profit. It all goes to you. If after a time, the loan is paid off, you will own the property free and clean and all the equity is yours.

LIMITED PARTNER #3 – INTERNAL REVENUE SERVICE

This is one of the few time you love the IRS. They can actually help you 3 ways.

1. Depreciation – the IRS allows you to depreciate (take a paper loss) on any residential income property improvements for 27.5 years. That loss would first be applied against any cash flow or debt reduction that you have for the property and then against your ordinary income to a maximum of $25,000. (Talk to your CPA)
2. Capital Gains, Installment Sales and Tax-Deferred Exchanges – The IRS allows you to sell your property so that your profit is taxed at a lower rate than ordinary income. You may also defer all your taxes if you do a 1031 Exchange or spread out you taxes with an Installment Sale.
3. Business deductions – When you purchase income producing real estate, you are in effect purchasing a business. If you decide to manage the property yourself, you should set up a fictitious business name for a management company and set up an office in your home where you do your business. This will allow you to get business deductions such as car expenses, Internet services, telephone costs, and office supplies. (Again, talk to your CPA)

CAN A PERSON MAKING $30,000 PER YEAR PURCHASE $1,000,000 OF REAL ESTATE?

This is an interesting question. At first you might think, no way! How can you qualify for $750,000 - $900,000 worth of loans? How can you come up with a down payment of $100,000 - $250,000?

For sure it would be impossible if you were buying a personal residence for $1,000,000. Your personal income wouldn't support the loan payment.

However, when you purchase residential income property, things are different. First of all you need to be living within your means from your salary and have good credit. Next the lender will look at the investment property you are purchasing to see if the rents paid by the tenants will pay for the expenses that will be generated by the property. If the property will support itself, you will be able to borrow a large percentage of the purchase price considering you have a down payment and maybe some money for reserves. The tenants rent will pay the mortgage payment and other expenses, not your personal income. Actually, if the property just broke even, your personal income would go up because you would be paying less taxes due to the depreciation you receive from your investment property.

The biggest challenge will be finding the down payment and I will share some ideas with you on that later.

THE REAL ESTATE MARKET “MARKET”

Earlier, we discussed how some of the major stock brokerage companies have large marketing budgets and advertise regularly on television, radio, magazines and newspapers. They have an international market that they can work with.

On the other hand, real estate sales are a local market. You will see some national advertising for the larger franchise companies such as Coldwell Banker, Century 21, and ReMax but the ads will be branding ads, not specific property ads.

TGR Realty – Income Property Specialists had an advertising budget that was very small in comparison. My specific market is Bakersfield, California. I was not looking for sellers in other areas or buyers that do not want to buy in my area.

Now when you are the book stores looking at the magazines, try to find some dedicated to investing in real estate. I doubt very much if you find one, and if you do, it will probably be about real estate in the local area. Most marketing of properties is actually paid for by individual agents with small advertising budgets.

OTHER WAYS TO MAKE MONEY WITH REAL ESTATE

Over the years I have heard lots of different philosophies from the GURUS on how to make money from real estate. All of these philosophies can work if done at the right time with the correct knowledge and of course, they can all fail if done at the wrong time with the wrong knowledge.

I would like to quickly cover some of these philosophies with you. People are different and they have different goals and motivation. More than one of these ideas can be combined to help you reach your goals.

FLIPPING TO MAKE A PROFIT QUICKLY

There are several ways to make a large profit quickly from purchasing or tying up a piece of real estate. The most common way is called "flipping" which involves buying fixer uppers. These can include bank owned properties, properties that are pre-foreclosure, or properties that are owned by individuals that have personal challenges maintaining their property.

An individual will look for a distressed property that can be purchased for a low price. He spends money and energy to rehab the property. He then puts it back on the market and sells it for a profit.

Here was a picture of my first fixer-upper.

JUST KIDDING!

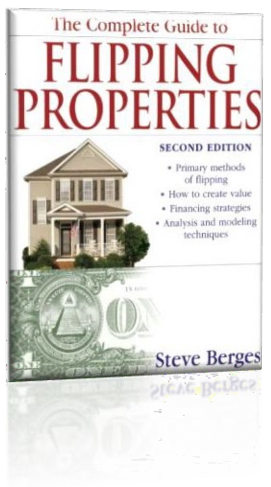
I actually did flip single family homes three times, all early in my investing career. I did most of the work myself. I made money on one transaction, broke even on one, and lost money on one. The secret to this process is very specialized knowledge. There has been a lot of flipping going on over the last few years with bank-owned properties. You have to know what you can pay for the property so that when you sell the property:

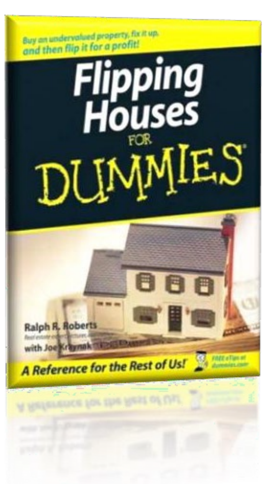
1. The cost you paid for the property, plus
2. The acquisition cost, plus
3. The costs to rehab the property, plus
4. The holding costs, plus
5. The sales costs, subtracted from
6. The sales price is a positive number, preferably a large positive number.

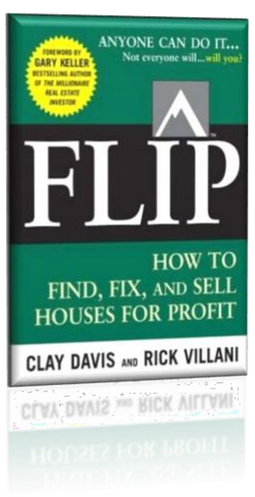
Example: You find a little single family home in poor condition that looks like you can make a profit. Here are the expenses:

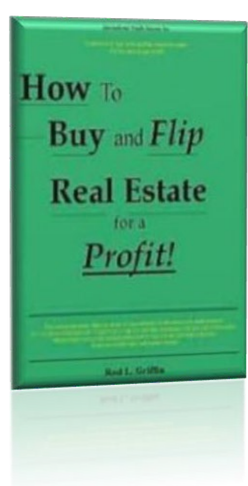
Purchase Price	$60,000
Costs to	900
PurchaseFix-up	6,500
Costs Holding	700
Costs Costs of	5,500
Sale Total	$72,900
Sales Price	$95,000
Profit	$22,100

Now, there are a lot of Guru's out there who can teach you how to do this. I suggest that you go to eBay or Amazon.com and look under "flipping real estate" or "real estate investing."









There are some other ways to control properties to flip without owning them. You can lease-option them. Here you have control of the property for a specific period of time and then you can choose to execute your option and purchase the property or decline to execute your option and the control of the property goes back to the owner. During the option period, you can find a buyer and double escrow the property. You can also do what is called a lease-purchase. Again you get control of the property but you are obligated to purchase the property during the option period. The owner then knows that in the future he will no longer own the property.

IS FLIPPING REALLY INVESTING?

My contention is that flipping is not really investing in real estate, but instead is more like owning a business that offers a product or service. In a business, you have to keep providing your service or selling your product over and over to have a continuous stream of income. The same is true of flipping. There is no passive income generated. If you flip a house or set of units, you can make a one-time profit. However, to get a continual stream of money, you would need to continue to flip over and over again which takes personal time and energy.

To me, <u>investing</u> is developing a yield over a long period of time with the idea of generating net worth and/or cash flow for the future. I think that flipping can be a good business for someone who doesn't have a quick way to generate money for down payments.

Fix something up, sell it, use some of the proceeds for the next project and some for investing in long hold properties.

Another philosophy is to combine fixing up properties with long hold properties. There have been several properties that I purchased that needed fixing up, but once I had them in good shape, I kept them as part of my investment portfolio.

There are a lot of other ways to participate in investing in real estate that I will not go into detail here including:

1. Purchasing tax liens
2. Purchasing discounted notes and trust deeds
3. Participating in a syndication or limited partnership
4. Purchasing shares in a REIT – Real Estate Investment Trust

THE FOUR WAYS TO MAKE MONEY INVESTING IN REAL ESTATE

One of the first things that I learned about the benefits of investing in real estate is there are four different ways that an individual can make a profit. They are:

1. **Appreciation**
2. **Debt reduction**
3. **Tax benefits**
4. **Cash flow**

WHICH OF THESE FOUR YIELDS WOULD BE THE MOST IMPORTANT TO AN INVESTOR?

Over the years, I have seen times when some of these profits are higher and at other times, they are hard to achieve. For example, when I started investing in real estate in 1976, we were in a cycle of high inflation. People who were purchasing saw double digit yearly returns from appreciation. Also at this time, the tax benefits were very good, with high depreciation rates. But also at this time, the interest rates were high and the cap rates were low, so that just about every property that was purchased with a loan had negative cash flow.

Well, as you know this philosophy led to me losing 95% of my real estate holdings in 1986.

When I started investing again in 1992, the tax benefits had been reduced and inflation was more under control. Interest rates were still relatively high. People who had purchased rental properties were not seeing high appreciation and the management hassles were sometimes more problems than it was worth to own the property. Property could now be purchased where the cap rate was greater than the interest rate and it was possible to get a positive cash flow. This really was the time to purchase properties. (Art and Bill)

Let's discuss the four different yields over the next few pages.

APPRECIATION AS A YIELD

There are two ways to become a millionaire investing in real estate.

1. Purchase one million dollars' worth of real estate and hope it doubles over the years.
2. Buy one million dollars' worth of real estate and pay it off.

If both happen, you are a multi-millionaire.

There are all kinds of statistics that measure the average rate of return over a period of time for all kinds of assets. To be honest, I don't pay any attention to them and I didn't try to sell real estate based on the promise that a person's property will go up in value over time. (Net Worth Asset)

I look at appreciation as a yield that you can't count on, but if you do get it, it is a bonus. I definitely think it is smart to try to buy when prices are low. But I don't make my decisions based on that trend exclusively.

We have already discussed a way to try to measure time versus yield using the Rule of 72. One of my first goals was to purchase $1,000,000 in residential income property. Once I attained that goal, I could come up with the deduction (falsely) that if property value increased 6% per year, in 12 years my property would be worth $2,000,000. (72 ÷ 6% = 12 years – Rule of 72). That would be a great selling point to advertise to buyers. But I didn't feel comfortable marketing that way.

Both appreciation and debt reduction build equity but do not provide cash flow. There are ways to convert your equity to cash flow which we will discuss later in this book.

Historically, it can be said that real estate will go up in value over the years. Of course, this a cyclical event where values go up and down but for the most part over a long period of time, real estate will outperform the inflation rate. With leverage, your yield compounds significantly which we explained earlier.

I just finished reading a book about people that became real estate millionaires over a period of time, the author supposedly doing it in two years. By the way, the book mentioned above was published in 2008 and I would predict that a lot of those people discussed in the book are no longer millionaires.

I have already advised you not to purchase real estate for the benefit of appreciation. If you are purchasing it as a net worth (capital gains) asset, unless you have a lot of holding power, you put yourself in a risky position. I have emphasized that you buy rental property as a cash flow asset and if you do get appreciation, it will be an added bonus. Remember the difference between speculators and investors. Of course, the absolute best time to buy property would be when prices are low, starting to trend up and have a positive cash flow at the time of purchase. Then you have the best of both worlds.

Next, we will talk about debt reduction.

DEBT REDUCTION AS A YIELD

We have mentioned that there are four was we make a profit (yield) from owning residential income property.

1. Appreciation
2. Debt Reduction
3. Tax Benefits
4. Cash Flow

We already know that speculators get excited about appreciation and investors are looking for cash flow. The tax benefits are there automatically, but should you really get excited about debt reduction?

What do we know when we get a fully amortized loan on a property and start making payments. We know that we will make a payment that includes interest and some principle so that the loan will be fully paid off on the due date.

Most people also understand that the first payments are mostly interest and very little principle. In fact, if you get a loan with a 30-year amortization period you will pay a lot more than the loan balance over the years.

Let's look at an example, a $100,000 loan amortized for 30 years at 7% interest. Your payment would be $665.30 per month for 360 months for a total of **$239,509**. That is $139,509 more that you borrowed. After 5 years of payment, you would still owe $94,131. After ten years of payment you would owe $85,812 and after 15 years (180 payments) you would still owe $74,019. Fifteen years is a long time to earn an equity position of under $26,000. But there is a yield being created!

You would think that you could do a lot better in T-Bills or Money Market Funds.

Example: You purchase a fourplex for $200,000. Now, suppose you knew for a fact that the property was not going to appreciate for the next 30 years. You also knew that the property was going to break even for the next 30 years and provide no cash flow. And because you have so much tax losses from other properties that you own, you will not get any tax benefit from owning this property. Let's also hypothesize that you have a choice of making a down payment of 20%, 15%, 10%, or 5% and amortizing the loan for 15 years, 20 years, 25 years or 30 years. What kind of yield would you obtain using these different scenarios when you have finished paying off the loan?

	30 years	25 years	20 years	15 years
25% down	4.63%	5.56%	6.95%	9.27%
20% down	5.38%	6.46%	8.07%	10.78%
15% down	6.34%	7.61%	9.52%	12.71%
10% down	7.70%	9.25%	11.57%	15.45%
5 % down	10.03%	12.04%	15.07%	20.14%

These are still pretty good yields for any investment asset.

TAX BENEFITS AS A YIELD

Prior to 1986, the government allowed investors to have tremendous tax advantages. At different times, residential income properties had accelerated depreciation, component depreciation, and 15-year straight line depreciation with no limit to the amount of loses that could be taken in a year. These tremendous tax benefits allowed high-income earners to same $1000’s of dollars on their taxes.

This all changed when Congress passed The Tax Reform Act of 1986.

Today, the real estate tax laws still give some great benefits. In most cases, an individual can write off a maximum of $25,000 of losses against their ordinary income. (Active real estate agents have no limit of losses.) Any additional loses can be carried forward to the next year. (Check with your accountant about your individual circumstance.)

What this means is that if the property broke even (income – expenses = $0), you were in the 39% tax bracket, and you had the maximum depreciation of $25,000, you would get to reduce your ordinary income by $25,000 and you would have to pay $9750 less to the government which meant that you had a cash flow of $9750 per year compliments of the government.

You also can get tax benefits if you sell your property, capital gains tax rates are normally less than ordinary income tax rates. You can do a 1031 tax-deferred exchange which carries your gain forward to the new property(ies) you purchase, or you can sell using an installment sale which can spread your gain over several years. I will explain these processes in more detail on the next few pages.

First of all, let me remind you that I am not a CPA or accountant. I have taken classes on the tax consequences of owning real estate and will share what I know. One of the first people you need to place on your team is a competent tax consultant. Very early in my working years, I met an accountant that owned the franchise rights to several H and R Block businesses who was also a real estate investor. Besides doing my taxes now for over 30 years, Dick has also purchased many properties from me over the years and also allowed me to sell some of his properties.

As a buyer and as an owner you should know the different strategies that you can apply to your real estate portfolio.

“The tax laws were written for business owners and investors.” – Rich Dad

TAX-DEFERRED EXCHANGES

Tax deferred exchanges are a valuable way to grow your portfolio. Over the years, I have helped dozens of clients complete successful 1031 tax deferred exchanges.

The time to think about exchanges is before you place a property on the market. In order to prevent problems from the IRS, all the paper work, the listing agreement, deposit receipt, and the escrow instructions should show that it is your intention to complete a tax deferred exchange.

A 1031 exchange will allow you to sell a property held for investment and purchase one or more properties of equal or greater value and pay no taxes on the transaction. The sale of any real estate which is not the owner's residence, and which has been held for investment or business use (not dealer property), can qualify for a 1031 exchange including:

- Rental house
- Vacant lot
- Office building
- Store
- Warehouse
- Duplex
- Multi-family units
- Farm
- Ranch
- Mini-storage center
- Resort rental property

All qualifying property is interchangeable (i.e. bare land for a rental house is OK). Almost all exchanges involve the use of a neutral party called an Accommodator.

What is a tax-deferred exchange?

The tax-free exchange, as it is commonly called, is really not "tax free." It is actually tax deferred. This means the tax that would normally be due on the disposition (sale) of the property is delayed or deferred until the future *if* the transaction conforms to the rules of Section 1031 of the Internal Revenue Code. In such an exchange (called a "1031") the property that the client wants to sell is called the "old" property or the "relinquished" property. The property the client wants to purchase (exchange for) is called the "new' property or the "replacement property." Assuming that you want to execute a 1031 exchange, the term *sale* refers to the marketing of the relinquished property and the term *purchase* refers to the acquisition of the replacement property; together these equate to a successful 1031 exchange.

Why Would an Investor Want to Exchange?

The following is a list of possible reasons why an investor may want to exchange:

1. The client is determined to sell for some/any reason (age of neighborhood or maintenance expenses or whatever).
2. The client is tired of residential rentals and wants commercial or vacant land.
3. The client wants to switch into faster-appreciating investments.
4. The client wants to get rid of appreciated non-income-producing vacant land and buy income-producing investments
5. Federal and state capital gain taxes can exceed 22 percent of the capital gain.
6. The client sells fully depreciated property and buys a more valuable property, thus creating a new tax shelter.
7. The client wants to leverage up his or her investments.
8. The client wants to defer payment of tax liability to take advantage of the “time value of money.”
9. The client wants to rearrange his or her holding in anticipation of death.
10. The client wants his or her investment property to be near his or her principal residence.

Some sellers believe that a tax deferred exchange involves two parties trading their property to each other. This happens only rarely. Most exchanges involve three parties:

1. a buyer for the exchanger's property
2. the exchanger, and
3. a separate owner who sells the new replacement property to the exchangor.

Also exchanges can involve multiple parties and multiple properties.

There are very strict rules pertaining to completing a successful tax deferred exchange that include disclosures in the listing agreement and escrow instructions and time limits to identify properties and close the escrow.

INSTALLMENT SALES

What is an Installment Sale?

An installment sale involves the seller of a property carrying back some of all of his equity in the form of a loan to the buyer.

Example: Phil sells a fourplex that he owns free and clear for $180,000. He agrees to accept a down payment of $40,000 cash and loan the buyer $140,000 with a note and first trust deed. Some of his gain is immediately taxable. As he receives principle reduction each year, it is taxable in the year he receives it. It spreads the gain over several years, keeping the seller in a lower tax bracket.

Advantages of an Installment Sale

Advantages of an installment sale to the buyer(s) include:

- Low closing costs – There is no loan origination fee, credit report, or discount points. There are some closing costs, which are optional but should be recommended by an agent, such as a survey, title search, title insurance, and home inspection.
- Fast closing – There is no waiting period for mortgage approval. Closings can take place in days, not weeks.

The advantages to the seller(s) include:

- Fast closing, for this type of sale gets the property off the market, and the seller receives some of the proceeds in just a few days.
- Creation of an annuity for the seller and heirs.
- Future property taxes paid by the buyer(s).
- Buyer purchases homeowner insurance policy showing the seller as first mortgagee.
- Buyer responsible for all future maintenance
- Seller collects negotiated interest rate instead of depositing sales proceeds in a bank at a lower interest rate.
- This type of sale spreads the capital gains tax over the life of the loan. Taxes are paid only on the portion of the capital gain received in each year. The total payments are broken down and taxes paid as follows.
  1. Interest: Federal and state taxes, no Social Security or Medicare
  2. Cost basis portion: no tax
  3. Depreciated capital gain: 25 percent – could be as low as 15 percent (recapture)
  4. Appreciated capital gain: 15 percent maximum (could be as low as 5 percent.
- Seller in a lower tax bracket at retirement would pay even less taxes on the interest portion of the installment payments.
- Installment sale often used when the residential property needs repairs and does not qualify for new conventional financing.

Disadvantages of Installment Sales

There are a number of potential disadvantages of installment sale. A seller can decide if the advantages outweigh the disadvantages.

What if Buyer Defaults?

If the buyer defaults, foreclosure is the seller's remedy. Foreclosure costs money for an attorney and takes some time. With proper safeguards, the possibility of foreclosure can be reduced or the costs of the foreclosure can be reduced. As a general rule, the smaller the down payment, the greater the risk of foreclosure.

NOW THE BAD NEWS

Next let me tell you that all three of these tax benefits, depreciation, tax-deferred exchanges, and installment sales are subject to change at any time by the whim of Congress and I have already mentioned it is very important to you as an INVESTOR to keep up with any potential changes that our political representatives are considering.

CASH FLOW AS A YIELD

We know that rental property should generate an income. Every month there should be money coming from the tenants. In almost every case, you will also have expenses that you must pay each month as the owner of the property. These can include mortgage payments, taxes, insurance, maintenance costs, utilities, legal fees, etc.

If you purchase a property where the income collected for the year is greater than the expenses for the year, the property has positive cash flow. Cash flow is very easy to determine after you have owned the property. It is not quite so easy to predict prior to purchasing the property.

As time passes and as your purchase more cash flow properties, you may get into a situation where your net cash flow is greater than your personal expenses. If you remember, earlier we discussed your Wealth Ratio. When your passive income is greater than your expenses, your Wealth Ratio is greater than one. You have won the Game of Money. You are financially independent.

In most cases, your cash flow will not be taxable because you have enough depreciation to offset your income. At the same time, your loan balances are reducing each month giving you more equity. And lastly, if the property is appreciating, you get an added bonus.

Also, as your portfolio grows, you have more security in case of a major expense such as replacement of an air conditioner or roof to one of your properties. You other positive cash flow properties can absorb a negative cash flow property.

BUILD PASSIVE INCOME OVER THE YEARS

If you are using the Art and Bill method to purchase property, your cap rate will be higher than your interest rate and you will have a positive cash flow. If your rents appreciate at the same rate or a greater rate than the rate of your expenses, your cash flow will increase year after year.

If you have the passive income, you really shouldn't care about your net worth. Equity only comes into play if you decide to sell or refinance your property. You can Win the Game of Money by just acquiring cash flow properties over a period of time.

In the beginning of this section, I asked you:

WHICH OF THE FOUR YIELDS, APPRECIATION, DEBT REDUCTION, TAX BENEFITS, OR CASH FLOW SHOULD BE THE MOST IMPORTANT TO AN <u>INVESTOR</u>?

The answer I hope you replied should be:

CASH FLOW

COMPARISON OF ASSET CLASSES

Here is a brief comparison of asset classes based on four ways money can be made.

ASSET CLASS	APPRE-CIATION	CASH FLOW	DEBT RED.	TAX BEN.
SAVINGS, ETC		X		
COLLECTABLES	X			
GOLD	X			
STOCKS, MF	X	?		
REAL ESTATE	X	X	X	X
BUSINESSES	X	X	X	X

An investment needs to make sense today and tomorrow. Invest for in order:

1. **Cash Flow**
2. **Tax Advantages**
3. **Capital Gains**

ANOTHER PHILOSOPY OF INVESTING IN REAL ESTATE AS A SPECULATOR

This is another way of investing in real estate using appreciation as the method of making money. Instead of buying low and selling high, which triggers capital gain taxes, an investor can borrow equity from a property which is a non-taxable event. You can live on the equity increase from one property each year.

Example: You purchase a $100,000 property every year for 10 years. We are going to speculate that after 10 years, each property appreciates a total of 50% (the property would have to appreciate a little over 4% per year). We also know that there is some debt reduction during this time. At the beginning of year 11, you go to a bank and refinance the first property you purchased 10 years before. It would be worth $150,000. Let's say that you net $50,000 from the refinance. That would be non-taxable income equivalent to earning about $70,000 from a job. Live on that income for the year. The next year, refinance property #2 that you purchased. If everything stays the same, you can do this for ten years, and then start over with property number 1 the eleventh year and so on for another 10 years.

Of course you are taking on some assumptions for this to work. You need to have some reasonable appreciation during the 10 years. You would hope that rents increase during the years and interest rates stay reasonable. You would also hope that the tax laws don't change that would have a negative effect on refinancing.

In this example, you are making money as a speculator, not an investor. You are living of hoped for appreciation, not monthly cash flow.

MY THOUGHTS ON INSURANCE

This may be an area that we disagree and I know insurance agents will argue with me about my philosophy on purchasing insurance.

I think of insurance as a giant pool of people, all kinds of people, who purchase a type of insurance with the concept that if they have a claim, the insurance company will come in and settle the claim so that the cost of the claim to the policy owner is a lot less that if he didn't have insurance.

There are different types of insurance for just about everything, life, health, disability, accidental death, auto, home, boat, rental property, liability, tenant, business, etc. In all these cases, premiums are made based on the risk. Insurance companies are in the business of making a profit. Therefore, they pay out less than they take in.

One of the things that I learned over the years is to compare having insurance to self-insuring. This can be done a few different ways.

Example: I have auto insurance with Farmer's Insurance along with a lot of other drivers, some good and some that are not so good. One of the decisions that Farmer's gives me is the amount of deductible I can pick. I can choose a $500 deductible or a $5000 deductible. In looking at the numbers, let's say that the difference in the premiums would save me $4500 in 5 years. If I believe that I can drive safely for at least 5 years without having an accident caused by me, it would be worth going to the higher deductible. If I am not such a good driver, I would be smarter to pay for the $500 deductible.

But there is more to this story. If I go with the higher deductible, my premiums are a lot less and therefore I have more discretionary income to invest in real estate.

REAL ESTATE INSURANCE

When it comes to real estate insurance, the first thing the insurance company determines is how much value they should cover a property for. I remember when I first started investing, I purchase a little property built in the 1940s with two small houses. One house had around 900 square feet and the other had close to 1000 square feet. I paid $46,000 for the property which was the fair market value. My insurance company gave me a quote based on a value of something like $120,000. I asked the agent why the assessed value was so much higher than the actual value. He told me that they have to figure the current cost to build a new property with the same square footageand use that figure instead of the current value. My thought was that if the property had a fire and wehad to build a new house or both homes, the property would be worth a lot more because we replaced an older property with a new property. If they insured the property for $46,000, the premiums would be a lot less. If I had a total loss, I could do one of two things.

1. I could take the $46,000, pay off the mortgage and go buy another property similar tothe one that was lost, or
2. I could go get a construction loan from a bank, borrow enough to build the new property, and then get a new take out loan for the maximum amount on the property.

Well, needless to say, I lose this argument every time I have it with an agent, even though I still believe in my hypothesis. That's why the insurance companies are so rich.

I do have some options though on my property insurance, the amount of deductible that I will pay on a claim. I look at this the same way I do with my auto insurance. Is it smarter to have a small deductible and pay a higher premium or a higher deductible with a lower premium and self-insure on the smaller claims. I will leave that decision to you.

THE THREE VARIABLES OF THE INCOME STREAM

Some of these ideas come from the book "**The Income Stream**" by **Robert M. Goodman**.

One of the statements that I have heard over the years about investing in residential income property is that when you buy an income property, you are really buying an income stream. The value of the property is based on the amount of the income being generated by the property.

Of course the yield is also greatly affected by the income that a property generates. But we must also take into consideration some characteristics of the income stream.

In the first chapter of his book, Robert talks about the testing of the income stream of a property using 3 variables.

1. **Quantity – the amount of income the stream produces.**
2. **Quality – the caliber of the credit behind the income stream.**
3. **Durability – the length and stability of the income stream.**

IT IS NOT REASONABLE TO EXPECT THAT ALL THREE ELEMENTS – QUANTITY, QUALITY AND DURABILITY WILL BE PRESENT IN THEIR HIGHEST FORMS IN ANY SINGLE INVESTMENT PROPERTY.

Which of three variables do you think is the most important? We will try to decide at the end of this discussion.

QUANTITY

Let's go into more detail. Usually in analyzing a property, the first thing that is looked at is the quantity of the income – the total of the rents and any other income being generated. This becomes vital if you are trying to buy, sell, or refinance a property. There are ways to affect the quantity both positively and negatively.

I once worked with an owner who wanted to sell his units. He had a policy that when a tenant rented a unit, the rent would remain the same for as long as the tenant stayed in the unit. He had a tenant who lived in the property over 20 years and his rent was about half of the market rent for a comparable unit. He had low Quantity but high Quality and Durability. Of course his yield was lower than it should be and the value of the property was affected negatively.

I also once saw an investor that would purchase a rental property and then allow an excessive number of people to live in each unit and also allowed pets. Because of this policy, he could get above market rents. He would then put the property back on the market to try to sell at a higher price.

He had high Quantity but low Quality and Durability. He also had higher wear and tear and maintenance costs. A smart buyer would recognize this and reduce the value of the property for these reasons.

I always had the theory of having my units in a clean and well maintained condition and trying to attract the best quality tenant for my type of unit based on renting for market rents.

QUANTITY VERSUS VACANCY

Let's suppose that you have an apartment to rent and you can offer it for $600 per month, or $550 per month.

What would happen if you try the $600 and it takes one month to rent? For the year you would collect $6600.

If you would rent the unit right away for $550, for the year you would also collect $6600, the same amount.

But might there be some differences in the quality of the tenants applying? Would I maybe have more applicants at the lower rent?

This is where good judgment and common sense come into play. If $600 was the market rent and the vacancy factor was low to average, then I would probably go for the $600. If $600 was slightly above market rent and the vacancy factor was high, than I would definitely go with the lower rent of $550.

QUANTITY VERSUS INCENTIVES TO RENT

There are times in the rental market when there are less quality applicants than vacant units. There is a tendency for the owner or management company to try to come up with some additional benefit (carrot) to shake in front of the prospective tenant. Frequently they will offer a "move-in special."

An incentive that I frequently see involves discounting the rent. I have seen one-half month rent to one full month rent off frequently offered. In my opinion, to offer a reduction off the first month's rent is extremely dangerous because if the tenant does not pay the 2nd month rent, you have no Quantity except a deposit that has already been used up. If I were going to use this technique, I would offer to give off the rent after 6 months or even 1 year occupancy as an incentive to keep the tenant in the unit paying their rent.

The real problem with this incentive is that if you offer one month free rent, you create an automatic vacancy factor of 8.33% from the date the unit is rented for the year.

If we rent the unit for $600 for one year we would collect $7200. If we have one month free, we lose $600. $600 divided by $7200 is 8.33% vacancy.

The “move-in special” that I like to use has to do with the amount of deposit. If the deposit was $500, my move in special would be a full month’s rent plus $100 toward the deposit. Then the tenant would pay an additional $100 each month until the full deposit was collected. (Is there a risk doing this? Of course, but it is an incentive that has no effect on the quantity of rent collected if the tenant complies.)

QUALITY

As was mentioned, Quality has to do with the caliber of the credit behind the income stream. When a prospective tenant fills out an application, my policy is to think that everything that was written on the application is a **LIE**! They must be checked out thoroughly to make sure they are a good risk. Once you give the keys to the applicant, you put yourself into a situation that costs time and money to rectify if you picked wrong.

One of the important things that must be considered is if the tenant does not pay their rent and has to be evicted or moves out leaving the unit damaged beyond the security deposit, how does the landlord protect himself? When you lose money this way, you are negatively affecting your income stream and the yield your property is producing.

There are several ways to try to improve the **quality** of the income for your unit.

1. Try to get a tenant with a long work history. (A salary is attachable)
2. Take a larger security/cleaning deposit.
3. If you have a problem, try to cut your losses as quickly as you can. Try to use the Cash-For-Keys method discussed in my “How to Manage Residential Income Propertyfor Maximum Profit” book. If that won’t work, start the eviction immediately unless youhave confidence the tenant will come up with the rent.
4. Get a strong co-signor. (This is my favorite) Now you have twice the power of collecting back money owed. One thing about deposits! When a tenant owes more in back rent that the amount of his deposit, the chances are that in most cases, the tenant will leave the unit dirty and even damaged because they have no chance of return of any money and they are trying to save up for the rent and deposit for their next unit.

If the process of trying to improve the Quality of the income source is ignored, the income stream for the investment property can decrease significantly and reduce yield or even cause loss of the property.

DURABILITY

An example of great Durability and Quality would be a 30-year triple net lease with a Fortune500 company. Usually the owner would have to give up some of the Quantity, by offering lower themarket rent to get this benefit.

For residential units, some owners and management companies require that tenants sign a lease. I have seen some for a 6-month term and a one-year term. I have mixed feelings about leases and think they apply better to single family houses and higher income apartments. I prefer month-to-month rental agreements for my bread and butter units.

THE WORST CASE SENARIO

Not to be Mr. Negative but there is a lot of risk involved from not doing everything that you can to secure the Quality of the Income Stream, both before the tenant takes possession and after they take possession. Unfortunately, if you make a mistake, there are a lot of expenses involved that can really add up. Here are some to review.

1. You lose rent from the time the tenant quits paying the rent until he vacates.
2. You may have to pay for an eviction which includes court and sheriff fees.
3. If the tenant files an "answer" to delay the eviction, you will have to go to court and it will cost more loss of rent.
4. If the tenant leaves the unit dirty and damaged, you may have to come out of pocket to pay the costs to get the unit back into rentable condition.
5. You will have to pay for the cost of remarketing the unit.
6. You will lose rent from the time you put the unit on the market until it is rented.

These expenses can go into the $1000's of dollars very quickly. Doesn't it make sense to do everything you can possibly do to get the highest Quality that you can and still rent the unit?

SUMMARIZATION

We have discussed Quantity, Quality, and Durability of the Income Stream. In residential income property Durability is mostly a matter of luck.

But when it comes to Quantity versus Quality what do you think is the most important?

Well I hope you agree with me that **Quality** is the most important variable of the income stream for the sake of the yield and security of ownership of the property.

Fortunately or unfortunately, I have been doing this process for so long that I have seen what can happen when the Quality is not there. I have made the mistake myself and have seen professional management companies do the same. No one bats 1.000 when it comes to screening and renting to tenants.

However, some do a better job than others of processing the application, offering the correct incentives if necessary and protecting the Quantity if things head in the wrong direction. This effort will make all other aspects of management a lot easier but **effective management starts with requiring those things that increase the credit behind the Quality of the Income Stream.**

WHAT CAN YOU DO WITH THE DIFFERENT YIELDSTHAT YOU GET FROM YOUR PROPERTY? ARE YOU A TRUE INVESTOR?

If you are trying to build your income property portfolio as fast as you can, you should be willing to make some sacrifices for your success. This will start by living on less than what you earn and saving at least 10% of your personal income to invest. But here are some additional things you need to do.

Two of the four ways that you make money in real estate produce income for you, either yearly or monthly.

Cash flow should end up in your checking account each month and you should accumulate it to apply to your next down payment.

Tax benefits reduce you tax liability to the government. You can either get the money monthly by increasing the number of dependents that you claim with your employer or when you file your income taxes and get a refund from the government. Determine how much you save by owing you real estate and put that cash into your “next down payment” account.

Debt reduction and **Appreciation** provide only equity to your property that can be tapped.

As your equity grows, it can be pulled out of your property in different ways to use to purchase more real estate.

Caution! There can be a tendency to use the profits from your investments to buy liabilities and doodads. Don't be tempted. Complete your investment acquisition plan before considering using any of your profits for toys.

These are "no-no's" until you have Won the Game of Money.

CHAPTER 7
ART AND BILL IN ACTION

Let's look at some scenarios to see the effect of the Art and Bill model and how it will help us build our Real Estate Money Machine.

First of all I want to redefine an important term – "**CAP RATE**"

Cap Rate – is the return you get from the cash flow if you own a property free and clear.

CAP RATE = NET OPERATING INCOME (NOI) ÷ PURCHASE PRICE

Example: On January 1st, you purchase a property for $100,000 and pay all cash. On December 31, you find that you collected $16,500 in rents and you paid $5,500 in expenses. Your net income for the year would be $11,000. Your cap rate would be:

$11,000 Net income ÷ $100,000 Down Payment = 11% cap rate

Case Study: You buy a piece of property for $100,000 with $20,000 down payment and a new loan for $80,000. Remember in Art and Bill, you earn the difference between the cap rate and the interest rate.

Case #1 Interest rate = 8% Cap rate = 11%

3%	11%

You would earn 3% on $80,000 plus 11% on $20,000
$2400 + $2200 = $4600 $4600 ÷ $20,000 = **23% yield**

Case #2 Interest rate = 8% Cap rate = 8%

0%	8%

You would earn 0% on $80,000 plus 8% on $20,000
$0 + $1600 = $1600 $1600 ÷ $20,000 = **8% yield**

Case #3 Interest rate = 8% Cap rate = 6%

-2%	6%

You would lose 2% on $80,000 and make 6% on $20,000
—$1600 + $1200 = —$400 —$400 ÷ $20,000 = **—2% yield**

CONCLUSION: THE GREATER THE POSITIVE DIFFERENCE BETWEEN THE CAP RATE AND THE INTEREST RATE, THE GREATER THE YIELD – ART AND BILL.

The time to purchase income producing real estate is when our Art and Bill ratio is a nice positive number. This is usually when everyone thinks it's a bad time to buy real estate, when there are a lot less buyers than sellers. This is when you can find motivated sellers.

Example: Cap Rate 7% Interest rate 6% - Bad Time to Invest,
Cap Rate 13% Interest Rate 9% - Good Time to Invest

A FEW MORE THOUGHTS ON ART, BILL AND CAP RATES

Here is something else for you to think about.

If the cap rate equals the interest rate, does that mean that you will break even on the property?

The answer is it depends on how you define breaking even.

Let's look at case #2 from on the previous page. Here we had an interest rate of 8% and a cap rate of 8%. The net operating income is $8000 which means if you owned the property free and clear, your cash flow would be $8000.

However when you pay a mortgage payment that includes 8% interest **plus principal**, each monthly payment has a little less interest and a little more principal. The payment on the $80,000 loan at 8% is $587.01 per month or $7044 for the first year.

In our example we said that you would earn $1600, 8%, from the $20,000 down payment.

That is not exactly true. If you paid $7044 to the bank out of the $8000, your net cash flow would only be $956 for the year, not $1600. $668 of the $8000 cash flow goes to principal reduction and is a forced savings account that the bank collects.

We said in our example that you would earn 8% on your $20,000 down payment which would be $1600. You actually earned $956 + $668 which equal $1624.

As long as the yield on you down payment ($1600) is greater than the principal payment to the bank (668), your net cash flow will be positive.

NET CASH FLOW = yield on loan amount plus yield on down payment – principal paid to lender.

LEVERAGE INCREASES YIELD

Example: You have the opportunity to purchase a fourplex at 123 A Street for $200,000. Gross income the first year is $23,000. Expenses other than debt reduction are $9660. 80% of the purchase price of the property is allotted to improvements, 20% to the land. The property has a 27-½ year depreciable life. Buyer is in the 38% tax bracket. The property appreciates 5% the first year. Loans will be at 7% interest, 30-year term.

Let's look at some hypothetical numbers using different down payments. **Table One** is the yield we would get considering cash flow, debt reduction, and tax benefits. **<u>We are not taking appreciation into account.</u>**

TABLE ONE 123 A STREET

	Pay All Cash	50% Dwn Pmt.	25% Dwn Pmt.	15% Dwn Pmt.
Cash Flow	13,340	5,356	1,365	(232)
Debt Reduct	0	1,016	1,524	1,727
Tax Benefits	(2,858)	(211)	1,117	1,643
Total Return	10,482	6,161	4,006	3,138
÷ Down Pmt.	200,000	100,000	50,000	30,000
Yield	**5.24%**	**6.16%**	**8.01%**	**10.46%**

Now, what I am trying to show you is a yield from a cash flow asset without taking appreciation into account. If you look at net worth assets, it almost all cases, your yield would be ZERO if there is no appreciation. In fact if A Street were to lose 5% of its value, we still have positive yield.

Table Two shows the **yield when we add 5% appreciation**. Our profit from appreciation will be $10,000, no matter what our down payment is.

TABLE TWO 5% APRRECIATION

Appreciation	10,000	10,000	10,000	10,000
Total Return	20,482	16,161	14,006	13,138
Yield	**10.24%**	**16.16%**	**28.01%**	**43.79%**

So, what can we learn from these tables? In Table One, we can see that our yields go up as we put less and less down payment. Our yield almost doubles from paying all cash to putting 15% down. In Table Two we can see the same results – less down higher yield. We can also see that the yield is almost multiplied by 4 times when we look at 15% down versus all cash. These yields will even look a lot better when we use 10% or 5% down payments.

LEVERAGE INCREASES YIELD

HOW I CAME UP WITH THE NUMBERS FOR THOSE THAT ARE ANALYTICAL
TABLE ONE

Purchase price of fourplex at **123 A Street** for $200,000 with a down payment of $50,000.
Gross income the first year is $23,000. Expenses other than debt reduction are $9660.
80% of the purchase price of the property is allotted to improvements, 20% to the land. The property has a 27-½ year depreciable life. Buyer is in the 38% tax bracket.
Loans will be at 7% interest, 30-year term.

Net Operating Income (NOI) = Gross income – expenses other than debt reduction
$23,000 - $9660 = **$13,340**

Cash Flow = NOI – total loan payment for the year
Payment for year = $11975
Cash flow = $13,340 - $11975 = **$1365**

Debt reduction – amount of principle pay down for the year.
Total Payment $11975,
$10,451 interest and **$1524 principal**

Depreciation for year = Sales Price X % of value of property that is improvements ÷ 27.5 (Depreciable life for residential income property)
$200,000 X .80 = $160,000 ÷ 27.5 = **$5818** (This is the loss on the property due to depreciation each year)

Taxable Gain or Loss on the Property = Cash Flow + Debt Reduction – Depreciation
$1365 + $1524 – $5818 = ($2929) In this case you have a net loss on the property of $2929 which would be subtracted from your other income and save you a certain additional amount of your taxes.

Tax Benefits of Owning the Property (Do you have to pay taxes or get money back) = Gain or Loss X .38 (Tax Bracket) If this number is negative, it means that the government owes you that amount. If it is positive, then you have to pay the government that amount.
25% down – ($2929) X .38 = **($1117).** Your tax liability for the year is $1117 less because of your ownership in the property.

Total Return from Owning the Property = Cash Flow + Debt Reduction ± Tax Benefits
Example: 25% down $1365 + $1524 + 1117 = **$4006**

Yield = Total Return ÷ Down Payment
Example: 25% down - $4006 ÷ $50,000 = **8.01%**

RETURN INCLUDING APPRECIATION (TABLE TWO)

Remember, we defined the difference between an investor and a speculator. An investor would look at table one to make his decision. If the investor does get some appreciation, that is a bonus.

A speculator would focus on row one of table two because the yields are higher and they believe that real estate always goes up in value.

So how did we come up with the numbers for table two?

We started with the total returns from cash flow, debt reduction, and tax benefits in table one. We then added the appreciation for the year. ($200,000 X 5% = $10,000). Then we divided by the down payment.

Example: 25% down - $4006 + $10,000 ÷ $50,000 = 28.01%

SO, IS THIS A GOOD DEAL

Let's say you were presented with **123 A Street** by your real estate agent. Based on your knowledge, would you make an offer to purchase the property or would you move on to another property? In other words, **"IS THIS A GOOD DEAL?"**

Before we answer that question let's look at one more example that I present in my video seminar "How to Build a Real Estate Money Machine."

EXAMPLE #2
456 B STREET

This property is in a bread and butter part of town. It is a tri-plex for $130,000. Gross income for the years is $21,000. Expenses other than debt reduction are $8400. 80% of the value of the property is allotted to improvements, 20% to the land. The property has a 27 ½ year depreciable life. Buyer is in the 38% tax bracket. The property appreciates 5% the first year. Loans will be at 8 ½ % interest, 30-year term.

	Pay All Cash	**50% Dwn Pmt.**	**25% Dwn Pmt.**	**15% Dwn. Pmt**
Cash Flow	12,600	6,602	3,604	2,404
Debt Reduct	0	491	737	835
Tax Benefits	(3,351)	(1,258)	(212)	206
Total Return	9249	5835	4129	3445
÷Down Pmt.	130,000	65,000	32,500	19,500
Yield	**7.12%**	**9.00%**	**12.71%**	**17.67%**

TABLE TWO – WITH 5% APPRECIATION

	Pay All Cash	**50% Dwn Pmt.**	**25% Dwn Pmt.**	**15% Dwn. Pmt**
Cash Flow	12,600	6,602	3,604	2,404
Debt Reduct	0	491	737	835
Tax Benefits	(3,351)	(1,258)	(212)	206
Appreciation	6,500	6,500	6,500	6,500
Total Return	15,749	12,335	10,629	9,945
÷Down Pmt.	130,000	65,000	32,500	19,500
Yield	**12.12%**	**19.00%**	**33.71%**	**51.00%**

As we can see, the same conclusions we used for the **A Street** property apply to our **B Street** property, the less down payment we make, the higher the yield. However, the yields are higher on **BStreet**. Does that mean that **B Street** is a better deal that **A Street**?

Is the B Street property **"A GOOD DEAL?"**

We will discuss this on the next couple of pages.

IS EITHER OF THESE PROPERTIES GOOD DEALS?

To start with, I can absolutely tell you what the answer is for the question "Is either or both of these properties a good deal?" The answer is:

"YOU DON'T KNOW!"

The reason you don't know is that you haven't compared **A Street** and **B Street** to a bunch of other properties that are for sale in your area. These might be great deals or they might be very poor deals. You have a lot more work to do before you can and should make a decision. But let's talk about these two properties for a while.

At first site, it looks like the **B Street** property has a higher yield and therefore would be the better deal. Again, **<u>that depends</u>**. It depends on its location. It depends on its condition. It depends on the quality of its income stream. It depends on the amount of deferred maintenance that occurs or will occur shortly. It depends on how management intensive it would be. If the **B Street** property is located in an area of your city that you have a chance of getting mugged or dying if you go down there, maybe it is not such a good deal. In Bakersfield, there were some areas that I would not list or sell properties either for my own account or for client's accounts.

But let's say B Street is one of the better bread and butter areas in the city and has been maintained and managed well over the years. **Does that make it a good deal?**

"YOU DON'T KNOW!"

Let's go back to the **A Street** property for a moment. One thing that pops out to me is that with 15% down, there is a negative cash flow of $232. As an investor, you want to have a positive cash flow. So why is **A Street** negative? Do you just have to put more down payment to get some cash flow? Well, if you put more down payment into the property, the yield will go down, per our tables.

Let's come up with a couple of other measurements for the **A Street** and **B Street** property, the **CASH ON CASH RETURN** and the **CAP RATE**.

For **A Street**, the Cash-on-Cash return would be the net cash flow divided by the down payment.

"A STREET CASH-ON-CASH = ($232) ÷ $30,000 = (.08%)

The cap rate would be the Net Operating Income (NOI) divided by the Sales Price.

"A STREET" CAP RATE = $13,340 ÷ $200,000 = 6.67%

Let me ask, "Why is the Cap Rate important to us?"

Remember, the whole theory of building a Real Estate Money Machine is to apply the Art and Bill Model to our investment property. What was the interest rate for this purchase? 7%. Is the Cap Rate higher than the interest rate? <u>NO!</u>

Sure, I do get a positive yield, but not from the cash flow benefit of owning real estate. This may be all you can find in your area at this time. You have 3 choices.

1. **Buy the property with a negative Art and Bill ratio**
2. **Buy property in another area that has a positive Art and Bill ratio.**
3. **Wait until the market in your area turns from a negative to positive Art and Bill ratio.**

In you live in an area such as San Diego, California, #1 and #3 may never be an option.

Let's look at **B Street** for a moment.

With 15% down our cash flow was $2,404.

Our cash-on-cash return would be $2404 ÷ $19,500 which is $12.33%.

The Cap Rate is $12,600 ÷ 130,000 = 9.70%.

Do you remember what our interest rate for this property – 8 ½ %, 1 ½ % higher that **A Street**.But for **B Street**, the Cap Rate, 9.7%, is 1.2% higher than the loan interest rate. This is giving us thepositive Art and Bill ratio that we want.

So, I want to ask you again, is B Street a good deal? Would you make an offer on it? 17.67% without any appreciation and 51% with 5% appreciation is pretty good. Are you ready to make an offer? Your answer should be:

"YOU DON'T KNOW!"

You still don't know because you have not compared it to a bunch of other properties in your area. They may be an exact duplicate of the **B Street** property on **C Street** with a cap rate of 10.4% or 11.2% that would be a lot better investment. You have some homework to do to familiarize yourself with what properties are on the market. You would also be smart to find out the numbers on properties that have already sold and closed escrow and properties that were listed and expired without selling.

To put yourself in a position where you don't have to trust anyone, you need to spend some time learning about areas, properties, and the numbers that go with them.

REAL ESTATE IS THE EASIEST OF ALL ASSETS TO LEVERAGE. IT IS EASIER TO BORROW MONEY FOR REAL ESTATE THAN FOR A BUSINESS OR PAPER ASSETS. – RICH DAD

SOMETHING ELSE WE CAN LEARN FROM A STREET AND B STREET

What I tried to show you so far is that **LEVERAGE INCREASE YIELD** and it is very important to **compare the cap rate of the property to the interest rate (THE ART AND BILL MODEL)**

Let me talk about a few other things. First of all, for any property that you purchase with a positive Art and Bill ratio, what would you see if you put zero down on the property? **The answer is that you would always have a positive number when you add the cash flow and debt reduction together.**

Ex: You buy a property for $100,000 for nothing down with an interest rate of **7%**. Let's look at different cap rates.

Cap Rate	NOI	Pmt. Amt.	Cash Flow	Debt Red.	Net Cash Flow
5%	$5000	$7984	(2984)	1016	(1968)
6%	$6000	$7984	(1984)	1016	(968)
7%	$7000	$7984	(984)	1016	32
8%	$8000	$7984	16	1016	1032
9%	$9000	$7984	1016	1016	2032
10%	$10,000	$7984	2016	1016	3032
11%	$11,000	$7984	3016	1016	4032
12%	$12,000	$7984	4016	1016	5032

So, what can we see from this table? As the cap rate goes up, the net cash flow also goes up. For the most part the cash flow is negative when the cap rate is less than the interest rate and positive when the cap rate is equal to or higher than the interest rate.

(The reason that there is a small positive cash flow [$32] when the cap rate is equal to the interest rate is because the loan is being amortized and therefore the interest amount is reduced each month and the principal amount increases each month).

Here is another question for you. What is my yield from cash flow when I put nothing down? Let's look at a cap rate of 9%. My net cash flow is $2032. But what was my initial investment? Zero! What is $2032 divided by zero? If you can remember your math, you cannot divide a number by zero. **Therefore, our yield is infinite.**

THAT'S A PRETTY HIGH YIELD!

SO WHAT HAPPENS TO THE YIELD AS THE YEARS PASS BY? WE'LL DISCUSS THAT NEXT.

"THE FIRST REASON PEOPLE STRUGGLE FINANCIALLY IS BECAUSE THEY MISMANAGE THEIR MONEY. THE SECOND REASON IS THAT THEY FAIL TO LEVERAGE THEIR MONEY. – RICH DAD

KNOW YOUR YIELD

A lot of "investors" are really "savers." People that put their money into savings accounts, T-bills, and Treasury notes are looking for a "safe" return. If their yield is less than the inflation rate plus amount of taxes that they will have to pay, they are losing money.

But you, as an investor need to know your yield on each property and review it each year. Your yield can change significantly over just a few years. Let me show you an example using our B Street property.

Ex: We are going to buy B Street with 20% down. All the figures from the previous example will pertain. We will allow a 5% yearly increase in rent, expenses, and appreciation.

End of	**1st Year**	**2nd Year**	**3rd Year**	**4th Year**
Cash Flow	3,004	3,634	4,296	4,990
Debt Reduction	786	856	931	1,014
Tax Benefits*	3	(269)	(549)	(834)
Appreciation	6,500	6,825	7,166	7,525
Total Gain	10,293	11,046	11,844	12,695
Beginning of Year Equity**	26,000	33,286	41,383	49,922
Yield***	**40%**	**33%**	**29%**	**25%**

*Cash Flow + Debt Reduction – Depreciation X .38

**Previous Year Equity + Debt Reduction + Appreciation

***Total Gain ÷ Beginning of Year Equity

As you can see, not only does the yield go down but also tax benefits reduce quickly Investors interested in increasing their wealth by increasing their yield should be constantly evaluating their equity position in their property to determine when it is the best time to **re-leverage**.

I tell investors that if they like their property, they should refinance or create a note to draw out equity. (Explained later when we discuss financing.)

If they don't like their property, they should sell it and do a tax-deferred exchange into either a larger property or multiple properties.

Whatever you do, as an investor, you must constantly keep in mind the yield on your investment.

THE SANFORD MODEL
MAXIMUM DEBT REDUCTION

Several years ago I attended a seminar with about 150 other real estate agents presented by one of the top agents and real estate trainers from southern California named Walter Sanford. He started his seminar by asking a very interesting question for the attendees.

"What is your exit strategy from real estate?"

Now most of the agents present scratched their head and didn't have a clue what Walter was talking about. I had an answer because I got into real estate sales to make it easier for me to work my plan to "Win the Game of Money."

So let me ask you the question, "What is you exit strategy from your job or profession?"

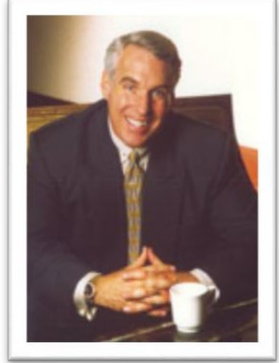
Next Walter explained his plan and I would like to present it to you now. His example involved purchasing one property per year. Let's say that on January 1st, you make a down payment on the Property #1 (in our example we will use a purchase price of $50,000, $5000 down and a new $45,000loan, 30 year amortization at 8.5% interest). We will assume that the property has a $100 per month cash flow. **You will add the $100 cash flow from Property #1 to your mortgage payment each month, therefore reducing the amortization period.**

On January 1st of the next year, you purchase Property #2 for $50,000 with a $100 cash flow. What do you think you will do with this $100 each month? **You will apply it to the payment on <u>Property #1</u>!** What result does this cause? It will again reduce the amortization period even more.

Each January 1st, you purchases a new property and applies the cash flow to Property #1. Based on continuing this example for each year, you will own Property #1 in 7 years. Once Property #1 is paid off, what do you think you will do with all the cash flow? You **will apply it to Property #2**, which will become free and clear in 2 years and 6 months.

When this happens, you will take all your cash flow and apply it to property #3 which will cause it to be free in clear in 1 year and 9 months. As the months pass, the time period for paying off each property will reduce.

Let's look at the numbers on the next page.



PURCHASE ONE PROPERTY PER YEAR.
ALL PROPERTIES PURCHASED FOR $50,000. $5,000 DOWN PAYMENT
LOAN $45,000 PYMNT $346.01 INT. RATE 8.5% 30-YEAR AMORT.
CASH FLOW IS $100.00 PER MONTH APPLIED TO PROPERTY #1

PROPERTY #1 – PAID OFF IN 7 YEARS

DATE OWED	YEAR	PAYMENT	PRINCIPAL PAYMENT	BALANCE
2009	1	$446.01	$1588.04	$43,411.96
2010	2	$546.01	$2976.28	$40,435.68
2011	3	$646.01	$4487.23	$35,948.45
2012	4	$746.01	$6131.73	$29,816.72
2013	5	$846.01	$7921.59	$21,895.12
2014	6	$946.01	$9869.66	$12,025.46
2015	7	$1046.01	$11988.92	$35.54

PROPERTY #2 – PAID OFF IN 2 YEARS, 6 MONTHS

DATE OWED	YEAR	PAYMENT	PRINCIPAL PAYMENT	BALANCE
2010	1	$346.01	$340.18	$44,659.82
2011	2	$346.01	$370.25	$44,289.56
2012	3	$346.01	$402.98	$43,886.58
2012	4	$346.01	$438.68	$43,447.98
2014	5	$346.01	$477.37	$42,970.62
2015	6	$346.01	$519.55	$42,451.07
2016	7	$1492.02	$14,886.21	$27,2584.87
2017	8	$1592.02	$17,428.11	$10,156.75
6 Mo.	8.5	$1692.02	$9,894.25	$262.52

PROPERTY #3 – PAID OFF IN 1 YEAR, 9 MONTHS

DATE OWE	YEAR	PAYMENT	PRINCIPAL PAYMENT	BALANCE
D2016	7	$346.01	$565.47	$41,885.61
6 Mo.	7.5	$346.01	$301.21	$41,584.40
6 Mo.	8	$2038.03	$2038.03	$30,936.55
2018	9	$2138.03	$2138.03	$6,991.19
3 Mo.	9.3	$2238.03	$2238.03	$681.18

Now the question is, “Is this a good model to apply as an investor?” And the answer is...

ABSOLUTELY NOT!

THIS IS AN EXTREMELY POOR MODEL TO APPLY IF YOU ARE AN INVESTOR!

We already showed you that your yield is increased by leverage and that your yield is very low if you own a property free and clear.

Now, if you said that you thought our investment strategy of maximum debt reduction was a good model, don't feel bad. Most of my students over the years agreed with you.

In my opinion, there is a time when you want to apply the "Sanford Model" which I want to discuss now.

When you start out investing, your goal should be to purchase as much property as youcan as fast as you can, using the Art and Bill model. You should be taking your cash flow from each property plus the money you save from your salary and **applying it to down payments**. It's kind of like the way you win the games of Monopoly or Cashflow 101 (Robert Kiyosaki's game). If you haven't played Cashflow 101, I highly recommend you either purchase the game or find someonethat owns it and ask to play it with them. I have three of the Cashflow 101 games, one Cashflow 202 and one Cashflow for Kids. We try to play as a family or with friends as often as we

In Monopoly, you purchase as many properties as you can afford as you land on them until all the properties have been purchased, Then you start applying you income for passing "Go" plus rent you collect as people land on your property to start buying houses and hotels so your cash flow increases more and more. Of course in Monopoly, they use a win – lose concept where you win when you take away all the money of the other players.

Cashflow 101 is different. To win this game, your goal is to build your passive income to be more than your expenses (Wealth Ratio greater than one) and get out of the "RAT RACE." Then you are on the Fast Track and want to buy your dream or build more passive income. You usually start buying small deals, single family houses and condos, and then a buyer comes along and wants to buy your property for more than you purchased it for. You sell it and then look to buy big deals, multifamily units with more cash flow. This is how you get out of the rat race. **Purchase more and more "cash flow" assets**

In both games, you want to buy as much as you can as fast as you can. You need to keep acquiring assets until "YOU OWN AS MUCH PROPERTY AS YOU WANT TO." Of course that will be a different number for different people.

Once you are in this position, you are ready to start moving into another mode, **THE INCREASE OF CASH FLOW AND/OR EQUITY MODE.**

THE INCREASE OF CASH FLOW AND/OR EQUITY MODE

Now you have some choices to make as to your next step.

Model 1 – THE HOLD AND KEEP THE CASH FLOW MODEL

With this model, you can work to increase your rents and lower your expenses so that your net cash flow increases over time and your wealth ratio becomes greater than one. This might be used by someone who is middle-aged or younger that has time on their side to allow the property to develop more equity through debt reduction and appreciation.

Model 2 – THE HOLD AND APPLY THE CASH FLOW TO DEBT REDUCTION MODEL

In this model, you take the cash flow and increase your payments on the principle to build up your equity faster. This is the Sanford Model.

Model 3- SELL PART OF YOUR PORTFOLIO AND PAY OFF THE LOANS ON THE PROPERTIES THAT YOU KEEP.

In 2004, I found that my properties were worth a lot more than what I had purchased them for. I decided to sell some of my units and apply the cash proceeds to pay off other properties I owned.

At the time I owned 98 rental units and a condo in Mammoth Lakes, California, all with loans on them, and my personal residence in Bakersfield which was free and clear. I sold 51 units, my condo in Mammoth, and my personal residence and ended up with 47 units, 32 of which were free and clean and a beautiful home is South Lake Tahoe which was also free and clear.

My 47 units create over $300,000 gross income each year.

Model 4 – SELL ALL OF YOUR PORTFOLIO.

If you want to get out of the real estate business, sell all of your portfolio over the years to spread out the gain. Live off the net proceeds or invest them into a fixed rate asset and live off the interest.

CHAPTER 8
FINDING YOUR TEAM
YOUR MASTER MIND GROUP
DEVELOPING A PLAN OF ACTION

What do you need to know?

Do you need to know as much as your real estate agent about writing the deposit receipt or opening escrow? Do you need to know as much as your loan officer about all the documents that are necessary? Do you need to know as much as your appraiser?

Henry Ford was an interesting guy. He did not have a great formal education. In fact, some people challenged his general knowledge. But Ford did understand how to take an opportunity, put together a plan, and then hire the experts in the fields he needed to execute that plan.

- You need to know what information is necessary to make an intelligent decision about the different aspects of acquiring and managing your assets.
- You need to know where and how to find that information.
- You need to know how to compare the information on one property to other investment properties.
- You need to know what information is more important than other information.
- You need to know which people are important to your mastermind group and how to determine if they can qualify.
- You need to have a plan of action.

Investing in real estate is a business. It must be treated like a business. You must think of yourself as the President and CEO of your business. I named by investment business **RSR Investments.**

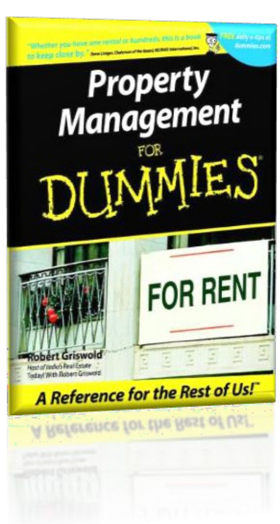
You are in the service industry. You are providing shelter to individuals and families. Your success will depend on how well you run your business. This is determined on how well you make decisions.

There are many parts to your business. Your business will not have employees. You will use independent contractors. They will be your advisors and belong to your mastermind group.

So who should you have in your mastermind group and how do you find them.

You can think of your investment business consisting of two parts:

1. Your acquisition business designed to find and add assets to your portfolio. Included in this group of people are:
    a. A top real estate agent who specializes in residential income property. (Preferably a Realtor®)
    b. Investment gurus – people's whose books, CDs, and DVDs will instruct you throughout your life.
    c. A smart escrow officer with a good title
    d. company A knowledgeable loan officer with a
    e. good lenderSeveral appraisers
    f. An insurance agent
    g. A good real estate attorney
    h. An accountant or CPA who knows the rules for investment property
    i. Property inspectors – termite companies, pool inspectors, heating/cooling inspectors, roof inspectors
2. Your management business designed to maximize the yield on the assets in your portfolio.
    a. A property management computer program or an accountant
    b. An eviction service
    c. Handyman – the most important person on this part of your team
    d. Gardeners
    e. Painters
    f. Electricians, Plumbers, Heating/Cooling Techs,
    g. Roofers
    h. Pest control company
    i. Local apartment owner's association
    j. A professional management company (optional)



A COUPLE OF QUICK IDEAS

A lot of people don't' know the difference between a real estate agent and a Realtor®. Let me briefly explain. First let me tell you about some organizations.

Your State Department of Real Estate administers real estate exams and issues licenses to real estate agents and brokers that qualify. They have rules and regulations that all licensed agents must obey and will investigate complaints and prosecute agents that are in violation.

A real estate agent is an individual that took some required classes and then passed a test administered by the Department of Real Estate.

A real estate broker is an individual that exhibits a period of experience as a real estate agent or professional education, takes a series of real estate classes, and then passes a real estate exam administered by the Department of Real Estate.

A Realtor® is a licensed real estate agent that joins a board of Realtors®.

The National Association of Realtors®, State Association of Realtors®, and local board of Realtors® are organizations that real estate licenses can join. As a member, the agent is designated a Realtor®. Local boards enforce a Code of Ethics through a Professional Standards Council or Committee which process complaints against a Realtor® from consumers or other Realtors®. If a panel finds the member in violation, the board may institute various disciplines.

All real estate agents are not Realtors® because it is not a requirement for a licensee to join any boards of Realtors®.

For more detailed information on this topic, please read my detailed special report:

CHAPTER 9
WAYS TO GET OR REDUCEDOWN PAYMENT MONEY

Probably the biggest challenge most buyers have is coming up with cash for a down payment. I know it was for me. Saving money was not on my Belief Window. If I had a financial emergency

I didn’t know how to live below my means and sock money away. In this section, I will sharesome ideas that you might be able to apply to help you with the “no down payment”

HOW I GOT MY INITIAL DOWN PAYMENT MONEY

Well, it’s 1976, and I have discovered the most fantastic way to become a millionaire, invest in real estate. I understand the tenth multiple, how $1000 becomes over $1,000,000 by doubling it 10 times. I understand that the higher the yield, the shorter the period of time. I see how leverage increases yield – the more leverage the higher the yield.

I was dead broke at the time and had no cash in the bank. Even if I could find a property for nothing down, there were still some costs in the purchase called “closing costs.” These included escrow fees, title policy, recording fees, tax proration, prepaid interest, and insurance for example. It’s hard to get a seller to come out of his pocket to pay these expenses. A buyer usually needs some cash to pay for these fees.

One of my favorite books which I have shared with you is The Richest Man in Babylon by Richard Clason. In it he explains the Seven Cures for a Lean Purse. The first cure is to START THY PURSE TO FATTENING. He explains that we should save 10% of our income, pay ourselves first.

When I looked at my situation, if I could save 10% of my income, it would take me a long time to get enough money to make a purchase. I didn't have the patience to wait.

The fifth cure of The Richest Man in Babylon is MAKE OF THY DWELLING A PROFITABLE INVESTMENT. I had purchased a home a few years before, and because of inflation, the home had increased in value. As a teacher, I was a member of the Kern Schools Credit Union, so I went down to their office and met with a loan representative. They were making second trust deed loans on personal residences and after applying and having an appraisal done, the credit union informed me that they would make me an $11,000 loan. If I remember correctly, the interest rate was about 11% and the payments were around $140 per month.

This was a big decision! These numbers were scary back in 1976. What would you do?

Here is how I looked at it. The interest on my second trust deed loan was tax deductible and therefore I would be able to write off the interest as a loss. This caused my taxable income to go down and therefore reduce the amount of taxes I paid the government. If I applied the money I saved to my payment, my interest rate and payment amount were really less.

Next, when I purchased an investment property, the government allows me to depreciate the value of the improvements on the property. This meant that my taxable income would go down even more and I would pay even less taxes, leaving more money in my pocket to help pay the second trust deed loan.

And then, of course, I owned a rental property that I had purchased with leverage and my equity was growing. I was on my way to becoming a millionaire!

SHOULD YOU USE EQUITY IN YOUR HOME TO PURCHASE INVESTMENT PROPERTY

Earlier in this book I asked you if your home was an asset or a liability. In almost every case, it is a liability because it takes money out of your wallet. However, let's take a closer look at a home.

YOUR HOME AS AN INVESTMENT

How can we "Make of Thy Dwelling a Profitable Investment?" Just about everyone that I know who has owned a home for at least a few years will name their equity in that home as their largest asset. As a person gets close to retirement, he may choose as a goal to have his home completely paid for so that his retirement income can be used for things other than interest payments. This is a point of view that I won't argue with. However, if you do have several years before you retire, you should evaluate your home as an investment vehicle that same way you would evaluate any other investment.

Example: Mr. C bought a home 10 years ago for $90,000, putting down $9,000 and borrowing $81,000. If Mr. C continues to make payments, he will own his own free and clear in 20 years. But what is his home after it is paid off, a net worth asset or a cash flow asset? The answer is net worth asset. His free and clear home allows him to live there with fewer expenses but does not create any cash flow. If he has no additional cash flow assets, how does he pay his ordinary expenses? I don't know about you but I see a lot of commercials on TV regarding reverse mortgages. This type of financing makes monthly payments to the owner of a home but also reduces his equity each month.

Today Mr. C's home is worth $120,000 and he owes $71,000. He therefore has equity of $49,000. This money is what is called "parked." It is not producing any cash flow. Let's hypothesize that this year his home will appreciate another $3,500. This would give him a **7.1% yield** on his equity ($3,500 ÷ $49,000).

Let's also assume that Mr. C's gross income has increased over the years so that he can now afford to make house payments of an additional $250 per month. He borrows $34,000 either by refinancing or obtaining a 2nd against his home. This leaves him with $15,000 equity in the home. Now let's look at the figures.

$3,500 appreciation ÷ $15,000 equity = **23.3% yield**

You can see that he has tripled his yield by re-leveraging his home. What should Mr. C do with the $34,000 he pulled out of his home? Now suppose Mr. C. is paying 6.5% interest on his loan and he can purchase rental property with a 9.5% cap rate. **Maybe Mr. C should consider investing in income producing real estate. He is using the Art and Bill Model on his home and investment property purchases because he can get a higher yield on the money that he borrows from hishome than he pays on the new home loan.**

If Mr. C continues his investment efforts, he could use the initial nest egg to Win the Game of Money and become financially independent

Another idea to consider is in regards to the first step in the Seven Cures for a Lean Purse - “Start thy purse to fattening.” Rather than trying to save 10% of his income until he has an adequate down payment to purchase some property, Mr. C could borrow the $34,000 and consider the $250 a month payment as his 10% payment towards savings...

*Actually his net payments will probably be close to half of this. Additional interest payments on his home are deductible on his income tax and if he uses the $34,000 for the purchase of investment property, it will give him additional tax deductions.

Check with your accountant for the actually numbers.

ADDITIONAL METHODS FOR CREATING CASH FOR DOWN PAYMENT

In 1976, I was teaching high school and making around $20,000 per year. I was also living on $20,000+ per year. So I really couldn’t save any money from my salary.

One of my early investment goals was to purchase as many properties as I could as fast as I could to add to my portfolio. However, I had one major challenge. After I took the 2nd trust deed on my home and invested it, I had no more access to cash for down payments. It would take me quite a bit of time (like maybe never) to save up more cash to continue buying properties.

Back then, when you purchased a property, it had a negative cash flow. There were good tax benefits to reduce my taxes but I was not putting any extra money in my pocket from my units.

I started accumulating a few properties but I had run out of my initial $11,000 I had received from the credit union. Where do I come up with more money?

As part of my education process learning about investing in real estate, I was reading and studying voraciously. I owned 11 units at the time.

Here are some things that I did to create more capital to purchase property.

1. I found a couple of friends, Bruce and Larry who wanted to invest and become my partners. Our agreement was that when I found a property that we all liked, I would put in my commission and they would match it with cash. We eventually owned over 40 units together.
2. I would refinance my properties as they developed some equity. I had some pretty good appreciation going on during this time caused by inflation. As a property developed some equity, I would go to the bank and get a new loan with a higher balance which would give me some more cash to work with.
   Example: I purchased a property for $80,000 with $8000 down and a $72,000 loan. A few years later the property had appreciated to $110,000. I could get an $88,000 loan, pay off the $72,000 loan and pocket $16,000 to invest in more property.
3. Another way of re-leveraging is to create a note secured by a trust deed on a property that I owned and then use that note as down payment to purchase another property.

Example: I own Property A that is worth $120,000 and has a $75,000 1st trust deed on it. I create a 2nd trust deed on Property A for $25,000. Property A still has $20,000 equity. I make an offer on Property B for $150,000 and use the $25,000 2nd trust deed on Property A as part of or all the down payment.

4. I purchase a fixer upper single family house for $60,000. I spend $7,000 for repairs. I sell the house for $80,000. I now have an additional $13,000 to investment in residential income property.
5. I developed an Internet based business that created cash flow to use for purchasing additional properties.
6. I don't know how motivated you are to Win the Game of Money. One of the things you might consider doing is getting a second job or having your spouse work to generate more net income to use.
7. Sell your liabilities and doodads for cash at a garage sale or yard sale.

Personally, in 1977, I decided to give up all my side activities and obtain my real estate agent's license. This would give me some added benefits as I was building my real estate portfolio.

a. I would learn more about the purchasing process.
b. I would have access to the MLS (Multiple Listing Service) and could spot new properties on the market faster.
c. I would save some money on the purchase price of any property that I purchase because I could reduce the price by my commission. I could also pay a higher price and be paid a cash commission if I wanted even though this was taxable income.
d. I could make money selling real estate to other people and this would give me more seed money.
e. I could do this in the evenings and during the summer instead of teaching summer school.

Now I'm not saying that you should go out and get a real estate license. But I am encouraging you to creatively think of some ways you could make some extra money to apply to down payment funds for new investments.

YOUR REAL ESTATE BROKER AS A SOURCE OF DOWN PAYMENT

Real estate agents realize that the more transactions they close, the more money they make. Those agents that sell owner-occupied homes usually will sell a house to an individual and then not have another transaction with the person for years and years, if ever. One of the advantages I have in specializing in residential income property is that I can sell several properties to the same buyer in a relative short period of time. The more down payment money a buyer has, the more property they can buy.

I want to share a couple of ideas involving your agent that you may be able to use that can give you a great advantage and also benefit your agent

. Here is an example:

Pete was a successful insurance agent who came to my seminars on investing. He had some initial money to invest, but wanted to speed up the acquisition process. A real estate agent earns a commission when he represents a seller or a buyer in a transaction. I was earning more income than I personally needed as a listing agent that sold to buyers represented by another agent.

I listed a piece of property that Pete wanted to purchase. My commission was 6% of the sales price. Pete put down 10% of the sales price and got a loan for 90% of the sales price. We closed escrow and I received a commission check. After the close of escrow, I agreed to loan Pete my commission. Pete agreed to make payments of 1/12th of the loan amount each month at no interest rate. Pete would then get back 6% of his 10% down payment to apply to purchase another property.

Example: Pete purchases a property for $150,000 with $15,000 down. At close of escrow, my commission is $9,000. Pete signs a promissory note for $9000 that agrees to pay me $750 per month for 12 months with the first payment due in 30 days and no interest. I give Peter $9000 cash for him to apply to his next purchase.

Pete purchased over 50 units from me over the years including a property for his office that included 6 rental apartments.

Do you see how this was win-win for both of us. Pete had more cash to work with to purchase units. I sold more property and made more money. I did this process with several of my clients. As I built up the monthly note income, I paid my bills with it and I took my cash commissions to purchase more property for myself.

DON'T BE AFRAID TO ASK YOUR REAL ESTATE AGENT TO PARTICIPATE IN THE TRANSACTION BY LENDING YOU BACK ALL OR PART OF HIS COMMISSION.

Here is another way you can work with your real estate agent to help you purchase more properties. At times lenders will reduce their loan-to-value (LTV) ratios so that they require more down payment from the buyer. An example would be that instead of making a 90% LTV, they reduced the loan amount to 80% LTV.

At times in the past, some lenders have allowed sellers to carry a 2nd trust deed behind the lender's 1st trust deed. At other times, they required cash to the loan with no carry back.

Example: Karen wants to purchase a property for $100,000 with 10% down but the lender will only make an 80% loan for $80,000. In the offer, Karen asks the seller to carry a 2nd trust deed for $10,000 at the prevailing interest rate. If the seller says OK, we have what is called an 80-10-10 loan. But suppose the seller doesn't want to carry the loan.

There are a few things that can be done. One is to structure the 2nd so that return is good enough that it can be sold to independent company or individual. Another way to solve this challenge is for the real estate agent(s) to agree to purchase the 2nd trust deed for his (their) 6% cash commission. They are then receiving a 10% note as commission instead of 6% cash commission. One agent might offer to purchase the other agent's part of the note for the equivalent of the 3% commission. I have done this several times over the years.

If the real estate agent is not hurting for cash, he can start accumulating notes as part of his assets or as a note becomes seasoned (a history of payments) the agent can use the note to purchase real estate for his own portfolio.

Example: For a period of time, interest rates were extremely high and sellers wanted to cash out. I ended up taking notes as my commission and selling them. If I sold a property for $100,000 and ended up with a note for $10,000, I had an Aunt Velma that would purchase the note for $6,000, the equivalent of a 6% cash commission to me. She became a valuable member of my master mind group for a couple of years when times were tough.

Finding individuals or financial companies that purchase discounted notes can be valuable team members.

PARTNERS

O.K., we have discussed a couple of ways you can use leverage with the help of your real estate agent. Let's discuss another method of purchasing property when you don't have personal cash to invest – using partners.

After I received my real estate license, to help me purchase property faster, I found partners who would put up cash that was equal to my commission. In some cases, I had just one partner and in others I had multiple partners. I would find the property and talk to potential partners about the purchase.

Example: I find a property that can be purchased with 10% down for $80,000. My commission was 6% or $4800. Bruce put up $4000 and I put up $4000. At the close of escrow Bruce has a 50% interest and I have a 50% interest. I was paid $4800 out of the escrow. This allows me to get into the property for nothing down with an additional $800 in my pocket.

Now if you don't have a real estate license, you can still find partners who are willing to invest money if you can write a good package explaining the benefits and yield potential of the property. One of the benefits you can offer is management responsibilities. You may be able to get 50% interest or you may have to take less. It is negotiable.

RED FLAG: I have had several partners over the years and for the most part, this process has allowed me to purchase properties that I could have not purchased by myself. But when you get a partner, you are essentially getting married. If you are not compatible, the partnership usually ends in a messy breakup. I strongly recommend that before you enter into any partnership, you either find a good real estate partnership agreement form on the Internet or have an attorney draw one up for you.

Some of the challenges with partnerships that must be addressed include:

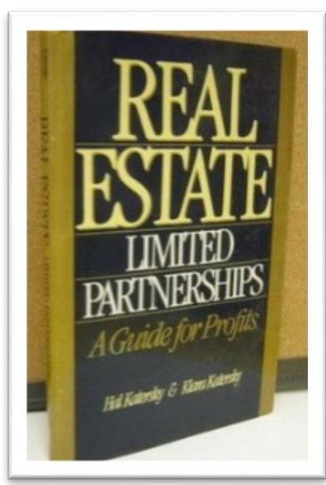
1. The responsibilities of each of the parties in the partnership, especially management.
2. The legal entity used to hold title
3. How the partnership can be dissolved?
4. What happens if one of the partners gets sued, divorced or dies?
5. How and when cash disbursements are to be made and how and when additional funds that may be needed are to be paid by the partners.
6. Buyout options.

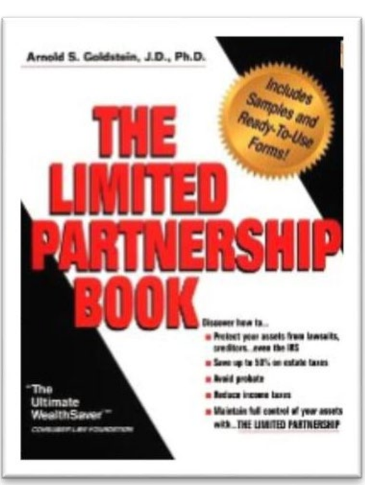
If you are not compatible with your partner(s) or one partner has more partnership burdens placed on them, things can get ugly.

LIMITED PARTNERSHIPS

Another way to get involved in real estate investing is in an entity called limited partnerships. There are lots of books and articles on how to become the general partner in the purchasing of real estate and have other investors provide money as limited partners. There are large real estate investment corporations that do this all the time. This can be done on a small scale also.

My advice is to only consider becoming a general partner after you have a lot of experience in other areas of acquisition.





HOW TO REDUCE YOUR DOWNPAYMENT WHEN THE BANK WON'T MAKE A HIGH LOAN TO VALUE

Over the years that I have sold residential income property, banks and savings and loans are constantly changing their loan policies. Sometimes they were very flexible with terms and sometimes very rigid. Of course the rules were different for 2-4 units versus 5 or more units.

At some times, in order for an owner to sell his property, he has to give some incentives. Of course, the first incentive is a low price. But in some cases, the seller can get a higher price if he is willing to carry a 2nd trust deed back on his property.

Let me give you a few examples.

There was a lender that for 2-4 units would allow what is called an 80-10-10 loan. This means that the lender would loan 80% of the value of the property, the buyer would put 10% down and the seller would carry a 2nd trust deed on the property for 10% of the value.

Example: The property sells for and is appraised for $180,000. The lender will make a loan for $144,000. The buyer will make a down payment for $18,000 and the seller will carry back (make a loan to the buyer) for $18,000.

Example: The buyer owns another piece of property with equity. Instead of the buyer getting a second trust deed loan of the seller's property, the buyer gives the seller a note and trust deed secured on the buyers other property.

Now, suppose the lender will make an 80% loan but requires 20% cash down payment. Here is another way to structure this transaction.

Let's say that the buyer puts down $36,000 and the escrow closes. That day the buyer and seller agree to go out and have a drink to celebrate. As they are talking the buyer mentions that he is looking to borrow money so he can purchase more property. The seller states that he does not need all his proceeds from the sale and he is willing to loan the buyer $18,000 secured by a note and 2nd trust deed on the property they just closed. Now, do you think that there is any stipulation in the loan documents of the bank that in the future the buyer can't encumber the property with additional loans? In my experience, I never saw such a clause. If the buyer could find someone that would take a big risk and loan him money in excess of his equity, the bank can't do anything about it. The bank is in the same position, 1st, with the same equity position.

But let's say that the buyer and seller have that drink before escrow closes, like when the original offer is made and they agree that at the close of escrow, the seller will loan the buyer 10% of the sales price as soon as escrow closes. There is a side agreement drawn and held outside of escrow. As soon as the escrow is closed, the 2nd trust deed is recorded and the seller gives the buyer $18,000.

Now you might say that this is kind of cheating or lying to the lender. Let's discuss this. The buyer is putting down 20% and getting a new loan for 80%. According to the bank, this is a legitimate 80- 20 loan. What is the difference if the buyer and the seller have an agreement upfront instead of after the close of escrow? The bank is in the same equity position.

Also, it should be a relatively safe loan for the seller because the buyer showed he was credit worthy by qualifying for the first trust deed loan from the bank. If you want the 2nd note to be even safer, you can have it created on another property with more equity or co-secured by two properties.

SOME OTHER WAYS FOR THE BUYER TO REDUCE THEIR DOWN PAYMENT

After an offer has been accepted, the transaction is given to a title company and an escrow officer is placed in charge to see that all of the requirements of the purchase agreement and the lender are fulfilled before the property is transferred from the seller to the buyer and the escrow is closed. The escrow officer determines based on the contract, who pays the different costs incurred in the escrow. It is called a settlement.

Sometimes there are ways that the costs owed by the buyer can be reduced.

To reduce the buyer's down payment, first of all, you must check with the lender to see what requirements they have. I am always calling different lenders to update their policies. You will find that most lenders make FHA and other owner occupied loans but do not make non-owner occupied loans for investors. You will probably have to go to a Savings and Loan or a loan broker for this type of loan. Your agent should know the best lenders and you can find out by calling different lending institutions, appraisers or escrow companies.

One way to reduce a buyer's costs is to ask the seller to pay for items normally paid by the buyer but allowable by the lender. This might include any of the items listed as buyer costs on the next page.

Now, why would the seller agree to pay the buyer's costs? The seller is looking for a net amount in his pocket. Let's say the buyer's costs are $1800. One way to do this is to increase the sales price by $2000 which would cover the buyer's costs + additional costs to the seller because of the increase in sales price. The net effect is the buyer is really financing some of his closing costs.

As part of the escrow, the seller would normally give the buyer the tenant's deposits. Another item that may help is the rent proration. At certain times, I asked the escrow to close on the 5th of the month. The seller would be responsible to collect the rent, but the buyer would be credited 25 days of prorated rent through the escrow.

With a little homework, a creative agent may be able to save the buyer a significant amount of money on their closing costs.

BUYER'S NET SHEET

Buyer's Name(s) ______________________________

Property Address ______________________________

	Debit	Credit
SALES PRICE		
DEPOSIT OF EARNEST MONEY		
ITEMS PAYABLE IN CONNECTION WITH LOAN		
Principal Amount of New Loan(s)		
Existing Loan(s) Taken Subject To		
Loan Origination Fee		
Loan Discount		
Appraisal Fee		
Credit Report		
Lender's Inspection Fee		
Assumption Fee		
ITEMS REQURED BY LENDER TO BE PAID IN ADVANCE		
Hazard Insurance		
Mortgage Insurance		
Property Taxes		
RESERVES DEPOSITED WITH LENDER		
Hazard Insurance		
Mortgage Insurance		
Property Taxes		
TITLE CHARGES		
Escrow Fee		
Lender's (ALTA) Title Policy		
Tax Proration		
Document Preparation		
Notary Fees		
Recording Fees		
Title Insurance Binder		
Rent Proration		
Tenant Deposits		
INSPECTIONS		
Termite Report		
Roof Report		
Home Inspection Report		
MISCELLANEOUS COSTS TO BUYER		
NOTE TO SELLER		
TOTAL CASH PAID BY/FOR BUYER		

CHAPTER 10
FINDING PROPERTIES

As an investor, one of your goals should be to have a large number of properties to evaluate anytime you are ready to invest. There are several ways to learn about properties that are fresh on the market. There are also ways for you to find about properties before they actually hit the market.

Things have changed so much with the Internet. It is also important to know that public information can be searched for or requested by anyone. Included in public records are tax bills, notices of default (property where a lender has filed a document stating that their loan is delinquent and may go into foreclosure), and tax defaulted properties (property where the owner is delinquent on taxes.) All of these will have the name and address of the owner on the documents. It is also easier to find phone numbers on line that ever before. I really recommend that you become familiar with these websites so that you can do research in both finding and evaluating property.

REAL ESTATE AGENT

I have told you that the most important member of your mastermind group will be your real estate agent. A good agent is worth their weight in gold.

My buyers will tell you that it is a big advantage to work with a top residential income agent. As a top listing agent, when I get a call from a potential seller, it takes me a day or two to get the information about the property and then do a market analysis. From the time I get the listing signed, I have 48 hours to place the listing into the Multiple Listing Service. As soon as the process starts, I will contact my buyers and give them a heads up about the property. Sometimes I have an offer for the seller right after the property is listed. I double end (represent the buyer and seller) in over half my transactions.

Good agents will know about properties that are not officially on the market but the owner would like to sell. Some of these can turn out to be good deals.

MULTIPLE LISTING SERVICE - MLS

Most Boards of Realtors® have a multiple listing service that they offer to the agents. If you join the board, you are required to place you listing in the MLS so that other agents can work on selling it. When I joined the board in 1977, we received a weekly booklet with all the listing written on the pages. Now the MLS is on the Internet for the agents to have access. Over the last several years, it has been expanded where the public can have access to some of the information on the properties for sale. You can see dozens of listings by different real estate agents that include information on how to contact them. If you see a listing that is interesting, do not call the listing agent. **Call your personal agent and tell him to get more information about the property.**

In some cases, you can have the best of both worlds. With the Bakersfield Board of Realtors® MLS system, your agent can add you as a client in the system and when a new listing is submitted by any agent you receive an email with the information immediately. In a lot of cases you find out beforeother agents.

LOCAL NEWSPAPER

I had my marketing assistant check the Bakersfield Californian newspaper every day for new ads either placed by an agent or a For Sale By Owner. If you see anything interesting in either category, contact your agent immediately.

SEARCH NEIGHBORHOODS

I remember when I first got my real estate license. I really didn't know what to do. One day I decided that I would get on a bicycle and ride up and down some streets in the east Bakersfield area making notes on every multi-family unit in the area. I had a little hand held cassette recorder and I picked six streets that were each about 2 miles long. What I did next was look up the owners and call them to see if they were interested in selling or exchanging their properties.

If I were looking for properties to purchase, I would go up and down streets with apartments andlook for <u>unloved</u> properties. Units that are boarded up, or have two foot weeds growing in the front yard. Once I had the addresses, I would order a property profile from an escrow company or check the tax records to find out information about the owner. Then I would call or write them.

EXPIRED LISTINGS

When the market was tough, one of the areas that I would focus on was expired listings. These are listings of properties that the owner wanted to sell but either because of poor pricing or poor marketing, they did not sale during the listing period. In a lot of cases, these are motivated sellers who may be more flexible in looking at an offer. Ask your agent for a list of expired properties for the last 6 months.

THROW-AWAY MAGAZINES

Whenever you walk into a convenience store such as 7 -11 or Arco AM - PM, you will see racks full of magazines of houses for sale. Once in a while you might find an income property for sale.

TAX DEFAULTED PROPERTY

Tax information on properties is public domain. A lot of information is on line and you can also physically go to the county tax collector's office and do research. Some of great opportunities that come along are from speculators that don't know what they are doing. They buy property that produces negative cash flow and then mismanage it and make their situation even worse. They have to keep the water on and do repairs affecting habitability of the units such as plumbing, heating, cooling, and electrical repairs. However, it they don't pay their property taxes when due, they have some time before their situation becomes critical. Sometimes, these owners will be very motivated to an offer to solve their problem.

FORECLOSURE SALES

I haven't had any experience purchasing properties that have come up for sale because of a foreclosure and are auctioned off at the court house. In most cases, the property is worth less than the amount of the loan and the lender has a representative that makes the first initial bid equal to the loan balance. It would be worth checking out what is going on today with the large number of foreclosures each week. You will need access to some cash in order to use this method. Usually these properties are placed back on the market with the lender listing the property with a broker.

WEBSITES

If you are looking for large properties or properties in a lot of different cities, a good website to check out is LoopNet**.** **http://www.loopnet.com**

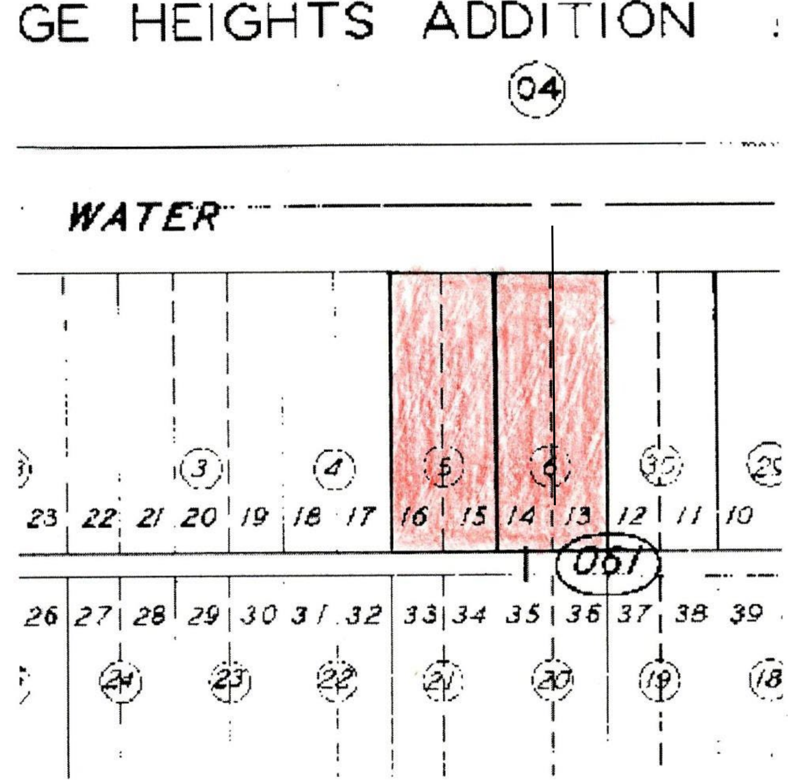
I still recommend that you use your own personal real estate agent to make the offer. Also, make sure you verify the income and expenses on the properties you are interested it. I have found that the information on some listings is not correct.

LOOKING AT PARCEL MAPS

A METHOD OF PURCHASING PROPERTY AND MAKING MONEY THAT MOST AGENT'S DON'T UNDERSTAND

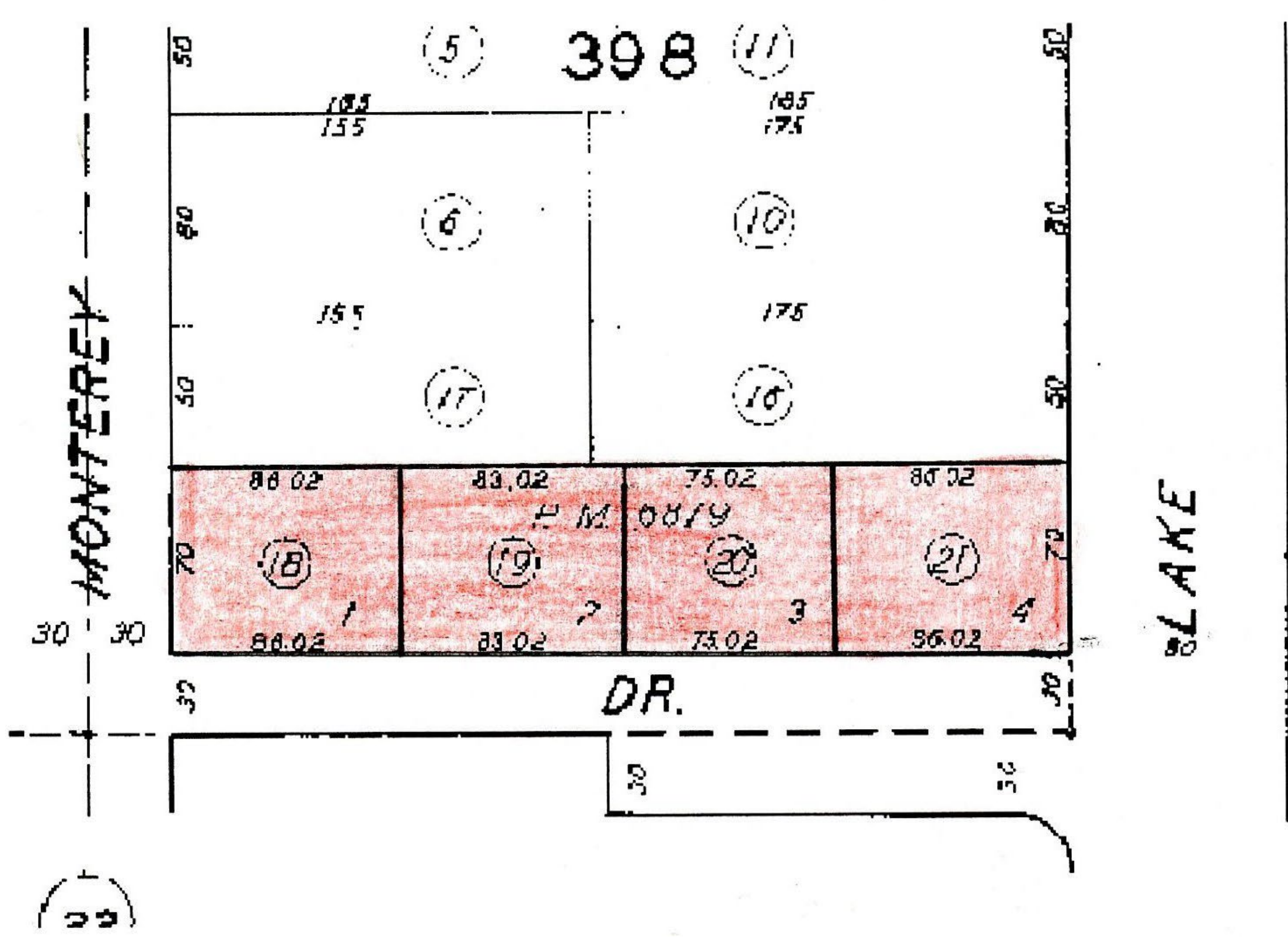
One of the important things to do when looking at a property for sale is to get what is called a parcel map of the property. This will show the size of the property and the number of lots and parcels that the improvements are on. I found numerous times properties listed by agents with more than 4 units on them that at first look hard to purchase because they would need a commercial loan – 5+ units – instead of a residential loan – 1 – 4 units. When I looked at the parcel map, I found that the units were really on 2 or more parcels which could be financed as separate properties with a residential loan.

Example: An agent listed 6 units on Water Street, made up of 2 triplexes facing each other with a common walkway down the middle. The property had been on the market for several months because financing was tough for 5+ complexes. The asking price for the six units was a lot less that the value of two individual triplexes. I ordered a parcel map and found that each triplex was on a separate parcel. (In Bakersfield, they have lots and parcels.) One or more lots can make up a parcel.) The taxes are charged on each parcel. In this example we are talking about lots 13, 14, 15, and 16. Lots 13 and 14 make up Parcel 6 and lots 15 and 16 make up Parcel 5. Two partners and I made an offer on the property that allowed us to get two loans for 80% of the sales price and the seller carried back a 2nd trust deed for 10% of the sales price. We had no problem closing the escrow.



Sometimes you will find a property with multiple units on one lot that has the capability of splitting the lot into smaller lots. In almost every case, an individual house on its own lot will be of more value than that same house on a lot with other houses.

Example: In the early 1980s, I found four individual houses that were for sale on <u>one</u> lot. This lot, lot 18, was made up of the whole end of a block with access to each house off the street. I purchase the property as a rental and it was doing fine. I took the parcel map down to the County Planning Department and had them review it to see if the property could be split into 4 different parcels. They informed me that it could be and that I would have to hire a civil engineer to draw up a map showing the new boundary lines for approval. We split lot 18 into 18, 19, 20, and 21. After paying the engineer and planning department their fees, I marketed the houses individually and made a very nice profit.



CHAPTER 11
PREPARING TO PURCHASE
WHAT YOUR AGENT SHOULD HAVE YOU DO BEFORE YOU WRITE UP AN OFFER

All agents work a little differently, but I want to present some ideas from my experiences of things that your agent should perform prior to preparing to write an offer.

Let's say you have picked Fred to be your agent after evaluating several agents.

If I were you, the first thing that I would do is set up an appointment at Fred's office to meet with him. If you are married or have a significant other, they should come with you to the meeting.

AN IMPORTANT PARTNER YOU CAN'T IGNORE

If you are married and you buy a piece of real estate, one of two things has to happen:

1. Your spouse has to be on title, or
2. They have to sign a quit-claim deed that they are aware of the purchase but do not claim any right to ownership.

I had several cases over the years where I met with a person who told me that they were the decision maker for their family and that their spouse would agree to any decision that they made. Then after I had worked with them for some time and we found a property that met their goals, they would take their spouse out to look at the property and then I would get a call:

"**My spouse won't let me buy the property!"**

If you have any investment partners or anyone else who you are going to depend on for your decision, it would be smart to have them come to the meeting also.

In fact, it would be smart if everyone who you were going to include as decision makers in your mastermind group, watched my **"How to Build a Real Estate Money Machine"** seminar or read this book first so they understood what you were trying to accomplish from investing in real estate.

When you attend this meeting, you should have a good idea of what you are trying to accomplish. A smart agent is going to ask you a lot of questions.

They are going to want to know about your credit and down payment. They should send you to a lender to get you prequalified before even considering writing up an offer.

Based on your discussion, they may provide you a list of properties for you to look at. Remember, you are only looking at the exterior of the properties to start with. Over the years, I very rarely put buyers in my car and took them out to look at properties. This process is to get you familiar with areas, types and quality of units,

Your agent should give you a copy of a blank purchase agreement and the different disclosures that will be part of the transaction for you to review before it is time to write up the actual offer.

Let's suppose that you check out several properties and one in particular looks interesting. Your agent should call the listing agent before starting any work on analyzing or writing an offer on the property.

Here are some questions that I ask that would be important for you to know.

1. *Is the property still available? If the answer is "yes," I would proceed to the next question. If the agent says that they have an accepted offer I would either ask for permission to put in a backup offer or ask the agent to call me if the offer does not come to completion*.
2. ***Why is the owner selling the property?***
3. *Is there an assumable loan on the property and if so, what are the terms.*
4. ***Will the owner carry some paper? (By the way, most agents can't answer questions two and four.)***
5. *How motivated is the seller? Ethically, an agent shouldn't answer this question unless he is instructed by the seller to do so?*
6. *Have you had any offers? What happened if they did?*
7. *Is there anything that I should know about the seller or the property that will help me sell your listing?*
8. *Do you have a current rent roll and an income and expense statement for last year or year-to-date?*
9. *Have you prepared an APOD (Annual Property Operating Data) form on the property?*
10. *Does the owner manage the property or is it professionally managed.*
11. *Has the seller had any inspections done on the property recently?*
12. *How was the listing price established? (Owner told the agent or agent did a market analysis?*

I would also get a Property Profile on the property from my title company which would give me a lot of information about the owner, the lot size, year built, square footage, taxes, how long the owner had owned the property, and even the sales price the owner paid. This is all public information. Sometimes you will find out that the owner is in default on the loan or has missed paying some property taxes which can help you as the buyer.

On the next page is a Property Profile on a fourplex that I use to own. Let's see what we can learn.

Property Profile			
Ownership Information			
Primary Owner			
Secondary Owner			
Ownership Description			
Site Address		7608 N LAURELGLEN BLVD	
Site City, St Zip		BAKERSFIELD, CA 93309-8812	
Mail Address			
Mail City, St Zip			
Telephone			
Census Tract		0028.18	
Legal Description		TRACT 4031 LOT 3	
Lot/Block		3/	
Housing Tract / Subdivision Name		4031	
Property Details			
Use Description	QUADRUPLEX		
State	CALIFORNIA	**County/Municipality**	KERN
RTSQ		**Total Rooms**	
Zoning		**Bedrooms**	9
Number Of Units	1	**Bathrooms**	5
Year Built/Effect Yr Built	1980 / 1980	**Basement Square Feet**	
# Of Stories	1	**Basement Description(s)**	
Lot Size		**View**	
Usable Lot Size		**Pool**	
Lot Depth		**FirePlace**	
Lot Width		**HT/AC**	BOTH
Square Feet	4,079	**Cooling Detail**	
Square Ft 1st Flr	4,079	**Heating Detail**	FLOOR/WALL
Square Ft 2nd Flr		**Roof Type**	
Square Ft 3rd Flr		**Construction Quality**	8
Additions - Square Feet		**Construction Type**	WOOD FRAME
Parking	Garage	**Exterior**	
Parking Square Feet	1,240	**Foundation**	
New Page Grid	2481-G4	**Building Shape**	RECTANGLE
Map Page Grid			
Tax Information			
Assessor's Parcel Number / Tax ID	380-241-03-00	**Assessor's Market Value**	$0
Alt Assessor's Parcel Number		**Exemption**	
Assessed Total	$286,000	**Tax Amount**	$4,531.19
Land Total	$55,026	**Tax Status**	Current
Improvement	$230,974	**Year Delinquent**	
Percent Improvement	81%	**Tax Rate Area**	1049
Sale Information			
Last Sales Date	November 19, 2004		
Document Number	0000284162	**1st Loan Amount**	
Sale Value	$480,000 (Full)	**First Loan Type**	
Last Transaction W/O $ Amount		**2nd Loan**	

Under Ownership Information, we would find the owner's name and mailing address. I wiped that out for this example. We can see the physical address for the property.

Property Details tells us it is a fourplex, built in 1980, 1 story, has 4079 square feet of living space, 9 bedrooms and 5 baths.

Tax Information gives us the Parcel Number, assessed values for land, improvements, total and % improvement. We can see the tax amount and tax status which is current.

Sale Information tells us that the property sold for $480,000 on November 19, 2004.

LOOKING AT PROPERTIES

When you go out and look at several properties that are for sale, it helps to have a form that allows you can take notes on each one. I know that after I look at a few properties, I can't remember what property had what amenity. This form will help you stay organized. Some of the information can be found on the listing.

INCOME PROPERTY EVALUATION FORM

Property #	1	2	3	4
Area				
Address				
List Price				
# of Units				
# of Bedrooms				
# of Baths				
Location 1-10				
Income/unit				
Total Mo. Income				
Year Built				
Lot Size				
Zoning				
City Limits				
List Date				
# of Stories				
Roof/Condition				
Elect. Condition				
Foundation				
Exterior				
Parking				
Cooling				
Sewer/Septic				
W/D Hookups				
Laundry Room				
Fireplaces				
Sprinklers				
Exist. Loan Amt.				
Payment				
Interest Rate				
Assumable				
Down payment				
$/Unit				
G.R.M.				
Comments				

CHAPTER 12

CONVENTIONAL LOAN BASICS

WHAT YOU LOAN OFFICER DOESN'T WANT YOU TO KNOW

The loan industry is one of the industries that make our country prosperous when they use good sense. By working with investors and entrepreneurs, banks allow people and companies to borrow money for capital. These "capitalists" purchase assets or develop a product or service that gives them the ability to make a profit. We talked about how banks made a profit by taking money from investors, paying them an interest rate, and then loaning that money at a higher interest rate. The margin between the two interest rates is the banks profit. This is their Art and Bill model. This can be a win – win proposition at its best.

A loan officer is a person that works for a bank, savings and loan, credit union, private lending company, or mortgage broker. In some cases a loan officer may be an employee on a fixed salary and need not be required to obtain a license. In other cases they may be on a commission schedule and obtain a license from the state they do business in. (In California, a loan officer would obtain thesame license as a real estate agent).

Just like real estate agents, a majority of loan officers specialize in owner-occupied, single family homes. In some cases, this may be the only type of loan their company makes. They are not familiar with the different programs and requirements for investment property loans. However, unlike most real estate agents who think they can sell anything, loan officers will tell you that they do not make investment loans and may even refer you to a company that does.

Lenders have different loan guidelines for different types of properties. Unfortunately, these change constantly. You may have to switch lenders and loan officers on a regular basis as you look for the best loans available. You will probably have one lender for 1 – 4 units and another for 5+ units.

TYPES OF LOANS

An individual that wants to live in the property can purchase a single family home up to a fourplex and obtain an owner-occupied loan. This loan will have a small down payment and relative low interest rate. Most lenders make this type of loan. These loans are usually cash down payment to a new loan and there is not much creativity involved.

An investor who wants to buy a single family home up to a fourplex will usually be required to make a larger down payment and the interest rate is slightly higher. It is harder to find lenders who work with investors and this will usually take some hunting. Sometimes lenders will allow secondary financing behind their first.

An investor that wants to purchase 5 or more units on one lot or a commercial or industrial property will usually have to put a significant larger down payment and the interest rate will also be higher. This loan market can be very difficult at times to find financing.

INTEREST RATES

Just like most other things, interest rates go up and down based on factors such as the supply of money, the economy, and the inflation rate. One of the important things that you need to do is understand “how” and “why” interest rates go up and down.

In 1977, I purchased a home with an interest rate of 9 ¼ %. I sold the home in 1992. During those 15 years, I didn’t see the interest rate lower than the 9 ¼ %.

The interest rate is one of the most significant influences of what is going on in the market. If a person wants to purchase a home, they will meet with a loan officer who will collect a bunch of financial data from the individual. Based on income, expenses, assets, and liabilities, the loan officer will determine the highest loan payment a buyer can afford and then determine the loan amount that payment will support.

Example: The homebuyer can afford a $950 per month principle and interest payment. If the interest rate at the time is 5%, they could get a $177,000 loan. If the interest rate is 7%, they can only qualify for a $143,000 loan and if the interest rate was 9%, the loan amount would only be $118,000.

If interest rates are going up, property values are going down!

From an investor's point of view, everything is the same except the loan officer is looking at the net income of the investment property after all expenses are paid. This information is provided by the appraiser to determine how much payment the property can afford to make. As the interest rate climbs, the loan amount is reduced either forcing the buyer to come up with more down payment, the seller to reduce his price, or the buyer to purchase a different property.

OTHER LOAN FACTORS

There are other loan factors that have a great influence on the prices of residential income property.

First is the loan to value. There are very low down, special loans for owner occupied purchasers such as FHA, GI, and Cal Vet. As I write this, the government is trying to help the housing crisis by giving first home time buyers a tax incentive.

Investor loans, non-owner occupied loans are grouped into two different areas.

1) 1 – 4 unit residential loans
2) 5+ unit commercial loans

Things that come into effect are:

1) Loan to value
2) Secondary financing allowed or not
3) Fixed interest rates versus variable interest rates
4) For variable loans, the index used, margin over index, and interest cap rates
5) Fully amortized or balloon payment
6) Personal recourse loans versus non-recourse loans
7) Reserves required

Commercial loans:

Over my 25-year career, I saw all kinds of changes in the types of loans that were made on larger residential income properties. Lenders were active in making commercial loans until 1986 when we had the Savings and Loans crisis. Then it was years before you could get a reasonable loan on a 5+ unit building. Most of the loans were 75% loan to value so a buyer needed more cash to purchase them. Some loans allowed a 10% second trust deed behind the first which helped. Most commercial loans are adjustable and have personal recourse.

"Not only do you want to make your money work hard for you, you want to make your banker's money work hard for you also." – Rich Dad

LET'S GO INTO MORE DETAIL ABOUT LOANS

Lenders are concerned with risk. Their goal is to get a nice return for their investors and reduce losses as much as they can. They have certain guidelines that they must follow issued by the government and policies for the particular bank. These guidelines are always changing and are different for individuals who are buying an owner occupied loan, an investor buying one-to-four units, and an investor buying 5 or more units (commercial loan). There are also limits on the number of real estate loans an individual may have.

I want to briefly talk about some of these and the risk involved for you as the buyer. However, I strongly recommend that you get some good books on financing and add knowledgeable loan officers to your team so that you have a complete understanding of this extremely important process. There is what is called a Truth-In-Lending law that protects you to some extent, but you need to really understand all the terms of a loan being offered to you.

Fixed interest rate loans – the interest rate remains the same for the length of the loan. Therefore the principal and interest payment will also remain the same.

Variable or adjustable rate loans – these have three different factors that you must look at. The first is the **INDEX**. This is what financial measurement tool the lender will use. I have seen the 11th District Cost of Funds and the LIBOR (London Interbank Offered Rate) as the two most common. When offered an adjustable loan, spend some time looking at the history of the index to see how volatile the index is. The next factor is the **MARGIN**. The margin is a fixed number that will be added to the index to determine the actual interest rate. The last factor is the **INTEREST RATE CAPS** which give the highest and lowest interest rate that the bank can charge no matter what happens to the index.

Example: I have two adjustable loans on 5-plexes that I financed several years ago. The index is the 11th District Cost of Funds and the margin is 2.5%. The interest cap rate low is 8.75% and even though the Cost of Funds has dipped below 2% which means my interest rate would be less than 4.5%, the cap rate has kept it at 8.75%.

Balloon payment – Some lenders do not want to have their money out in the market for a fully amortized period. They want their money back sooner. They therefore will set a date that the borrower must pay the balance owed on loan before it reaches the fully amortized date.

Example: The bank gives you a $100,000 loan, 7% interest, 30 year amortization, due in 15 years. Your payments would be $665.30 per month. After 15 years you would owe the bank a balance of $74,019. You would either have to pay with your own cash or obtain a new loan. Sometimes the lender will roll over the loan and extend it for some more years.

Due-on-Sale Clause – A lender spends a lot of time qualifying the borrower and the property for the loan. It some cases it is better for them to be paid off early than allow the loan to be fully amortized. Now a days, almost all loans have a clause that states that when an owner sells his property or transfers title to the property in any other way, the lender has the right to call the loan, to require that it be paid off. I have seen some lenders who will consider allowing the loan to be formally assumed subject to the new purchaser being fully qualified.

Pre-payment Penalty – Sometimes, lenders do not want to have their loans paid off by the borrower in a short period of time. They include a clause that allows them to charge a penalty to the borrower if the loan is paid off before a certain date. This can be expensive if you don't hold the property for the minimum time period. An example might be a penalty of 6 months of interest.

Recourse Clause – found mainly in commercial loans. This gives the lender the right to pursue other assets owned by you if you default on the loan and the lender does not recoup all of their proceeds. Most owner-occupied and investor 1-4 units do not have recourse clauses but it may still possible for them to foreclose on the property and try to collect loses from you.

Reserves – In some cases, the lender will not only require that the property break even, they may require a certain positive cash flow be factored into figuring the loan amount they will loan. Sometimes they will also require that the borrower show additional funds in a savings account to allow for emergencies such as having to purchase a new air conditioner or replacing the roof.

THE IMPORTANCE OF PREQUALIFICATION

We have discussed how the power of leverage can increase yield significantly. Leverage comes from OPM (Other People's Money). OPM can come from many sources.

- Banks
- Savings and Loans
- Mortgage Brokers
- Credit Unions
- Private Financing Companies
- Private Individuals including sellers and real estate agents
- Partners

As a buyer, the best position to be in is to be able to use all of these sources. A buyer who can qualify for a new conventional loan from a commercial lender has the potential to buy any property on the market. If you can't qualify for a loan, you will be very limited as to what you will be able to buy.

One of the first things you should do before you get too serious about buying real estate is make an appointment with a lender. If you have chosen a real estate agent to work with, he should send you to a lender that he does business with. This is the first thing that I do after my first meeting with a potential buyer. I sent them to my lender and got them prequalified.

The bank will be interested in your financial report card. The loan officer will give you a loan application and a list of the items that you need to submit to the lender to qualify. He will want to know your income, your expenses, your assets and liabilities. He will want to verify how much money you have for a down payment and the source of these funds. The lender will want a credit report. Do this up front before you ever think of making an offer on a property.

After the loan officer has reviewed all of your information, one of three things will happen:

1. Everything will check out fine and you will be able to qualify
2. You will have some minor problems that you will have to work on to get a position to get a loan.
3. You're in bad position and it will take a lot of work to get you qualified.

Now if you are a #3, it doesn't mean that you can't purchase property. It does mean that you will have very limited properties available to you unless you bring in some partners who can qualify for a loan.

I told you the story of how in 1986 I went from owning 100 units to 5 units. A few of the properties I lost were foreclosed on. A foreclosure is a pretty big red mark on a credit report. It was several years before I was able to qualify for a new loan. I still was able to purchase several properties without having to qualify but I was really limited in my selection.

Also I will be honest with you. If a person came to my seminar and wanted to purchase income property but couldn't qualify for a loan, I wouldn't work with them until they could qualify. The reason is that I had enough strong qualified buyers to work with that I didn't want to take the time struggling to find a special property just for a weak buyer. If I found a good property that had financing available that did not involve formal qualification, I would still sell it to a strong buyer.

Another reason for this attitude has to do with liability. If I am a listing agent, I have to make sure that I protect the seller that I represent. Any offer that comes to me on a property that involves the seller carrying paper needs to be treated like the buyer was going to a bank. I would require a loan application and a credit report. If the buyer is not strong, I cannot recommend that the seller make a risky loan to that person just to sell the property. I don't want the seller calling me back after escrow closes informing me that the buyer has defaulted on his loan payments and will I help him in the foreclosure process.

I would recommend that you work hard to become a #1 or find partners who are #1s and have them qualify for the loan and take title in their name. You should have a partnership agreement drawn up prior to making any offers.

Let's look at a scenario that has occurred frequently during my selling career. I have a nice property for sale. Let's say it's a fourplex for $140,000. I get a call from two different agents, Agent A and Agent B, that say they have written an offer for each of their clients and want to set up a time to present the offer to my seller. I arrange a meeting at my office with my seller and Agent A at 2:00 and Agent B at 2:30. Here are the two offers:

Agent A – Sales price $140,000, cash to a new loan. I ask Agent A if his buyer has met with a lender and been prequalified for a new loan and does he have a prequalification letter? Agent A says "no."

Agent B – Sales price $138,000, cash to a new loan. Agent B presents a prequalification letter from a reputable lender plus proof of down payment.

Which offer should my seller accept?

Unless I have a stupid seller that for $2000 wants to take the risk of taking the property off the market and hoping that Agent A's buyer can qualify, we would accept Agent B's offer.

A good buyer's agent knows that when he presents an offer to a seller, he is in a lot stronger negotiation position when he can say that his buyer has already prequalified for a loan with a lender.

In fact, as a seller's agent, if an agent comes to me with an offer from a buyer who has <u>not</u> been prequalified, I will counter the offer such that my owner's property will stay on the market and we have the right to accept another offer until the buyer provides a prequalification letter from a lender. I would never tie up a property for sale with someone who has not been prequalified.

Now does a prequalified buyer mean the same as loan approval? Unfortunately, the answer is "no." A prequalified buyer means based on the information received by the lender for the buyer, if everything can be verified correctly, the buyer will qualify. The lender still has some work to do. Also, there are a myriad of other contingencies involved such as the property appraising for the sales price and approval of inspections.

A smart agent will try to reduce the chances of the deal falling apart upfront before taking the property off the market and opening escrow. By removing those contingencies up front, it increases the chance of the escrow closing. One of the basic unknowns is, "Can the buyer qualify?"

QUESTIONS TO ASK A LENDER DURING THE PREQUALIFICATION PROCESS

1. ***What is the loan to value?***
2. ***Will the lender allow the seller to carry back a second trust deed?***
3. ***Will the lender allow the seller to pay any of the buyer's closing costs?***
4. ***Will the lender allow the down payment to be in any other form than cash?***
   Ex: a note on another property or personal property such as a car, jewelry?
5. ***Are there impounds required for the loan? (Taxes and insurance collected by the lender.)***
6. ***Is the loan assumable?***
7. ***Is there a due-on-sale clause?***
8. ***Is there a prepayment penalty?***
9. ***Is the loan fully amortized or is there a balloon payment?***
10. ***Is there a recourse clause in the loan?*** **If the loan goes through foreclosure and thebank loses money, can the bank go after other assets owned by the borrower?**
11. ***How many total loans am I allowed to have?***

MY PHILOSOPHY ON LOANS

Most people understand the next concept I want to cover, but I thought I would still review it. I would like to discuss a fixed rate, fully amortized loan. We start with the initial amount of the loan, the amortization period for the loan, and the interest rate. From these three numbers, the payment amount can be determined. There are a lot of inexpensive calculators that have the ability to determine the loan payment amounts and it is a necessary tool for you to have. You can also find websites with mortgage calculators available.

Example: The loan amount that you want to borrow is $100,000. The amortization period for the loan is 30 years, and the interest rate is 7%. The payment for the loan would be $665.30 per month. It would take 360 payments to reduce the loan balance to $0.00.

Payments on mortgages are paid at the end of each month. If you closed escrow on the 1st of the month, your first payment would be due the 1st of the next month. The first payment includes the interest owed on the principal balance plus some principal payment.

Example: Using the loan we discussed above, we make our first payment of $665.30. The interest for the month of 7% on $100,000 is $7000 divided by 12 months which equals $583.33. To find the principal paid on the loan, we would subtract the interest paid from the loan payment and get $81.97 ($665.30 – $583.33). The principal balance that is owed after the 1st payment is $99,918.03 ($100,000 – $81.97)

Your second payment of $665.30 would then be recalculated. To determine the interest the bank would take 7% of the $99,918.03 which is $6994.26 and divide it by 12 which is $582.86. Then they would subtract the interest ($582.86) from the payment ($665.30) and the principal reduction would be $82.45. Subtracting the principal reduction from the old balance gives us a new balance owed of $99,835.58. This process goes on month after month.

As you can see, the interest paid is reduced a little each month and the principal paid increases slightly each month.

What happens when the amortization period is changed to 15 years? First of all the payment goes up to $898.83, an increase of $233.53 or 35% higher than the 30-year loan. The interest paid the first month remains the save, $583.33. The principal paid is significantly increased to $315.49. The loan balance after the first month would be $99,684.50.

Let’s look at the long-term ramifications for each of these loans.

Let’s start with our 30 year loan and see where we stand after 5-year increments.

Loan Amount $100,000, Amortization period 30 years, Interest Rate 7%

End of Year	Interest Paid	Principal Paid	Loan Balance
5	34,050	5,868	94,132
10	31,599	8,319	85,812
15	28,125	11,794	74,019
20	23,199	16,719	57,300
25	16,217	23,701	33,599
30	6,319	33,599	-0-

Next we will look at a 15-year loan.

Loan Amount $100,000, Amortization period 15 years, Interest Rate 7%

End of Year	Interest Paid	Principal Paid	Loan Balance
5	31,342	22,587	77,413
10	21,910	32,020	45,393
15	8,537	45,393	-0-

Let’s say that you go to a lender and he gives you a choice of either of these loans for the purchase of a property. Which one will you pick? Let’s do a little more analyzing of the numbers.

First of all, we know that we can have our property free and clear in half the time with the 15 year loan. For our 30-year loan we are going to make 360 payments of $665.30 for a total of $239,508. $100,000 of this amount goes to principal so the **interest paid** by you to borrow $100,000 for 30 years will be **$139,508.**

For the 15-year loan, you are going to pay 180 payments of $898.83 for a total of $161,789. Again, $100,000 goes to the principal so you will only pay **$61,789** in **interest.**

THAT IS A DIFFERENCE OF $77,719 BETWEEN THE TWO LOANS.

SO THE QUESTION IS,

"DO YOU WANT A 30-YEAR LOAN OR A 15-YEAR LOAN?"

15-YEAR VERSUS 30-YEAR LOANS

I often asked my seminar participants which is better, a 15-year loan of a 30-year loan for a piece of property? Is it different on your personal residence compared to a loan on rental property?

You have probably learned that paying interest is bad.

Now the question comes down to:

Is it worth paying an additional $233 per month more for 15 years to save $78,000 in interest?

And I have a very simple answer!

It depends!

If a person is going to focus on the income box all his life and not worry about purchasing assets, then he is probably better off to get a 15 year loan. He should try to get out of debt as fast as he can. Even if he is a saver, paying off 6% interest is better than getting 2 or 3% from a bank or T-bill. The bottom line is the 15-year loan will be like a forced savings account, building his equity in his home.

However, if you are trying to accumulate assets and you can get a higher yield on your money than 7% you definitely should go with the 30-year loan. The 30-year loan gives you $2800 more per year to invest.

Also, if you go with the 15-year loan, the minimum payment you can make is $898.83. If you can't make that payment, you will go into default on the loan. With the 30-year loan, you can make a $665.30 payment and be current, **but there is no rule that says you can't increase the loan payment if you want.** If you got the 30-year loan but instead of the $665 payment you make the $899 payment, it will still pay off in 15-years.

Now there is still the argument that you may save .25-.50% interest with 15-year loan. My reply is, **you don't understand assets and Art and Bill**

What about 40-year loans or interest only loans? Amortizing over 40 years only saves you about $44 per month compared to the 30-year loan and an interest only loan saves you about $82.

<u>I recommend the 30-year loan as the best loan for most investors.</u>

How about the loan of your home? My same reasoning applies. Make the smaller payment and invest the difference using the Art and Bill model.

Example: I purchased an owner-occupied home in Bakersfield in 2000 for $185,000 with a 30-year amortized loan. Three years later I paid off the loan by selling an investment property that I had owned for less than 5 years.

ASSUMING AN EXISTING LOAN ON A PROPERTY

One of the important things to find out when investigating a property is the exiting financing. As a rule of thumb, I have found that most fixed interest rates are not assumable. Some adjustable rate loans are assumable and may be formally assumed. At times, when the lending market is tight, it may be the best avenue to try to work with the loan that is already on the property.

It is relatively easy to get information about the loan by reviewing a monthly payment statement and the original loan documents. This should have been done by the listing agent during the listing process. Information needed includes:

- Lender's name
- Loan number
- The loan balance
- Is the loan
- assumable?
- Assumption fee
- Interest rate
- Fixed or adjustable interest rate
- Index adjustments are tied to (11th District Cost of Funds, Libor, etc.)
- Margin and cap rates
- Amount of down payment to assume
- Payment per month
- Impounds included (collection of money by the bank to pay taxes and insurance
- Prepayment penalty
- New appraisal needed

Now if the loan has a due on sale clause and /or a prepayment penalty clause listing agent might not want the buyer's agent to talk to the bank directly informing them that the property is forsale.

I will explain "why" next.

SOME IDEAS ON ACQUIRING PROPERTIES WITHOUT FORMALLY ASSUMING THE LOANS

When I first started investing in and selling real estate, a lot of loans did not have a due-on-sale clause. A very common transaction involved what is called an **all-inclusive note and trust deed** or **wrap-around note and trust deed**. This was used quite frequently when interest rates were going up. It really was another method of applying the Art and Bill model for the seller.

Example: Fred owns a property with a $60,000 first trust deed at 6%. Fred agrees to sell his property to Ron for $100,000, $20,000 down and a note and trust deed for $80,000 at 7 ½% interest. Now you may think that the buyer is really paying $160,000 for the property because of the two loans. Actually Fred's loan includes the $60,000 first trust deed. Ron makes the $559.37 payment to Fred and Fred makes the payment to the lender in first position. Ron actually makes 1 ½% interest on the underlying loan and 7 ½ % on his $20,000 equity. (Art and Bill)

Now the lender would not find out about the transfer because they were still receiving payments from Fred. Then the lenders got smart. They started checking with the county recorder or the tax collector to make sure Fred was still on title. If title had transferred the lender would either require Ron to formally assume the loan or they could actually foreclose if they had a due on sale clause. We don't see very many of these transactions anymore but is there a way to take title to a property without a lender finding out?

Well, I wish I could tell you that there was a 100% sure fire way to do it but I can't. There are a few ways that the lender can find out who the actual owner is. I already discussed one way above when the lender checks with the county recorder or tax collector.

Here are some other ways:

1) The lender gets a loan payment for Ron instead of Fred.
2) A loan payment is delinquent and the lender orders a preliminary title policy to see what is going on in the property.
3) The lender receives a copy of the insurance policy and Ron's name is on it instead of Fred's.
4) The taxes are not paid and the tax collector notifies the lender.

<u>This is the way that I handled this situation but I caution you that there is a risk involved.</u>

In my book, How to Manage Rental Property for Maximum Profit, I strongly recommend that you get a fictitious business name for your management company, a business checking account with the management name on it, and a post office box to have your bills and rents delivered to.

1) When I had title transferred to me, I had the previous owner write a letter to the lender that my management company was now taking over the day-to-day operations of the property and to please send the loan payment coupon to the management's post office box. Now the lender would expect a check from my management company, not the previous owner.
2) Most of my transactions involved the previous owner carrying a note and trust deed and therefore having an interest in the property. I would assume his insurance and have me named as an added insured, or I would get a new policy with his name on it, and my name also.
3) I would make sure that the taxes were always paid on time.
4) I would be in position that if the lender did find out and call the loan, I had a way to refinance the property.

I was able to have this arrangement on several properties for many years before finally refinancing or selling the property.

This is a risky transaction and it is imperative that you have a plan on how to solve the challenge if the lender finds out and threatens to foreclose.

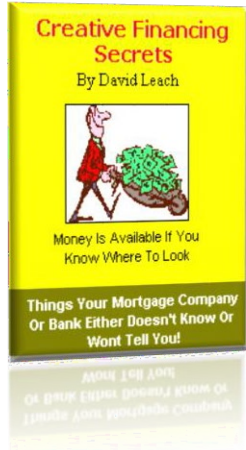
There are other ways to control a property without taking title to a property such as lease-option and lease-purchase which I will explain shortly in the next chapter on creative financing section.

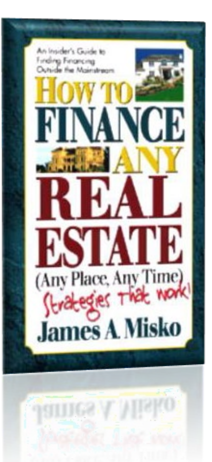
CHAPTER 13
CREATIVE FINANCING

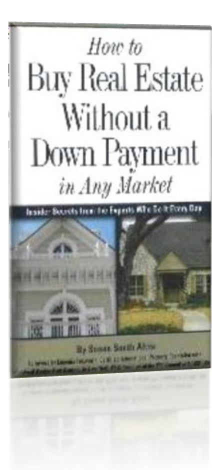
There are all kinds of books written by gurus about creative financing and purchasing real estate for nothing down. I recommend that as a professional investor you spend some time studying them. If you pick up one idea that helps you put together a transaction, it will certainly be worth your time.

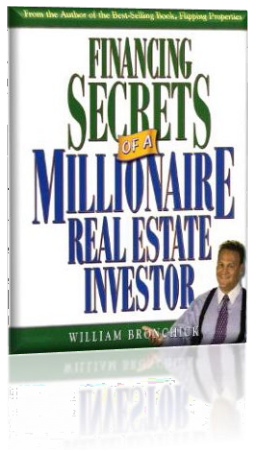
Next, I want to share some creative ideas that I used over the years to help me and my investors purchase properties that most other real estate agents and loan officers know nothing about.

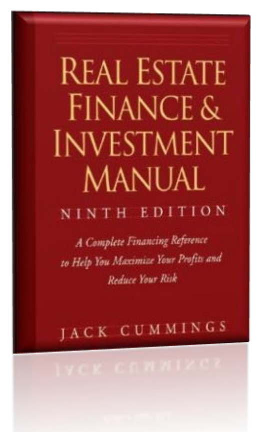
First of all, I want to discuss purchasing properties for nothing down.

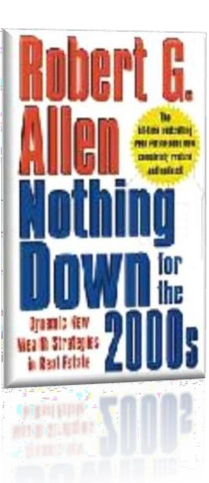












CAN YOU REALLY BUY PROPERTY WITH NO MONEY DOWN?

Before I discuss this, I would like to ask you two questions:

1. **Why would a seller want to sell his property for nothing down?**

Let's face it; there are times when a seller can be really hurting. He might have lost his job or gotten a divorce. He may be having severe management problems or maintenance problems that he doesn't have the cash to pay expenses anymore. As I look back, at certain times the market would create this type of atmosphere. There are owners right now that would deed their property to a stranger if they thought it would stop their bleeding and save their credit. However, if an owner had a property that was creating cash flow and other positive benefits, why would he risk selling it for nothing down?

2. **Why would you want to buy a property for nothing down?**

If you are a **speculator**, you might think that if you can just hold onto the property for a while, it will go up in value. Or you might believe that you can purchase the property for a real low price and find a buyer that will pay a higher price and make a quick profit.

However, if you are an **investor**, you are only going to purchase property that you can rent and will break even or preferably give you a cash flow. This eliminates a large number ***of the don't-want-them properties.***

Most sales of real estate have costs associated with it. Escrow fees, recording fees, transfer tax, title policy, tax proration, insurance, and maybe commissions, are all upfront cash expenses that have to be paid by someone. These can add up to $1000's of dollars. Maybe we can find a seller that will pay these costs out of pocket but it would be very rare. If the buyer can purchase a property without the seller receiving any cash proceeds but with the buyer paying the closing costs, is this really a "nothing down" transaction?

In my opinion, the term "nothing down" should mean that the buyer takes title to the property and doesn't have to pay one penny of his own money in the escrow. The buyer doesn't get a home equity loan or borrow money against his credit card or whole life insurance policy.

Based on this discussion, how many properties can really be purchased nothing down? Over the years, I have only come across a couple of real "nothing down" transactions.

AN EXAMPLE OF A NOTHING DOWN PROPERTY THAT I ACQUIRED

One day in early 1999, I got a call from an owner who had a property he wanted to sell and he asked me to look at it and do an appraisal. He stated that he wanted to sell because the professional management company he was using was not keeping the units rented and this was causing him to have a high negative cash flow. The property had ten rental units and was located on South K Street, one of the rougher areas of Bakersfield.

The first thing that I did was to get income and expense information from the management company so I could see how the property was performing. When I reviewed his profit and loss statement, I could quickly see why he wanted to sell. The property had a **negative cash flow** of about **$20,000** for the previous year.

I also determined that the property had a first trust deed of around $141,000 and the loan was assumable. However, the lender would require a significant down payment and the property to be put in good condition for them to allow an assumption to happen.

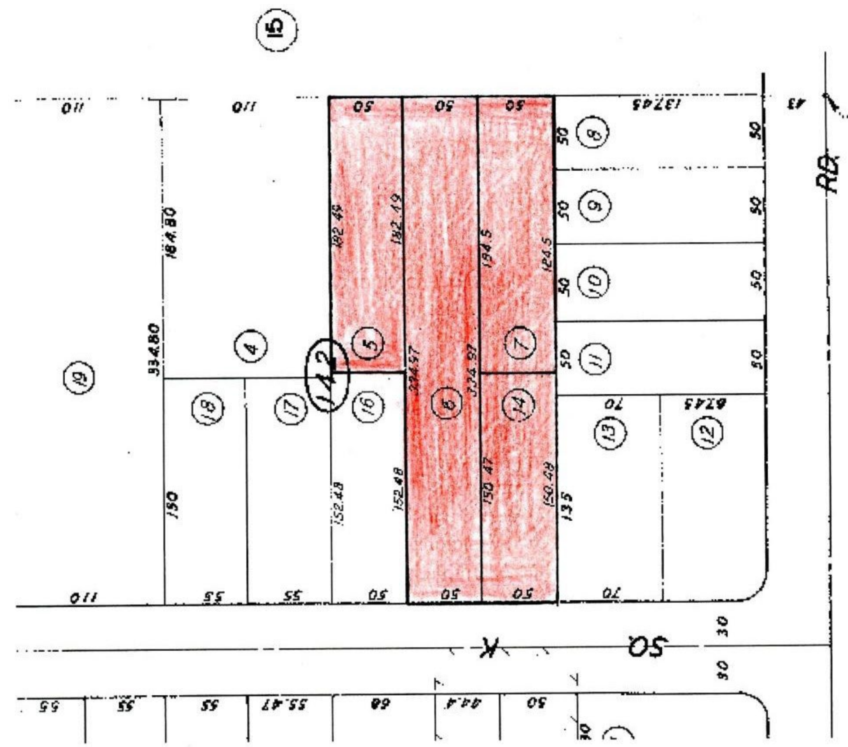
Next, I went to the management company and picked up the keys for all the units. I was informed by them that 4 or the ten units were vacant and a few other tenants were behind on their rent.

The day I arrived at the property to do my inspections, I was shocked with what I saw. The four vacant units were not severely damaged but they were full of trash. In one unit, you couldn’t take a step without walking on old garbage, clothes, or paper. All four of the units needed cleaning and some minor repairs.

To make a long story short, I had to tell the owner that I didn’t see how I could possibly find a buyer who would fix the property up, put down the required down payment and formally assume the loan. **The property was worth less than the loan amount.** Of course the owner was not real happy and we said goodbye.

A few months later, I got another call from the owner and he told me he was desperate and asked me again to see what could be done with the property. I again inspected the units which were in the same condition as before.

I ordered a property profile on the property and noticed that the 10 units were spread over 4 parcels, two had 3 units and two had 2 units. This made it possible in the future to finance the property with 1-4 unit loans.



I decided to make the owner a proposal on the property.

MY PROPOSAL

We would open an escrow based on a signed **lease – purchase agreement**. This is not an option agreement where I could back out of a purchase at the end of the lease. I was actually agreeing to purchase the property sometime in the future. The title to the property and the loan remained in his name so that if I defaulted on a lease payment, he could evict me off the property instead of having to foreclose. The lease would last until I did one of two things. Either the loan was (1) formally assumed or (2) the loan was paid off. At that time he would grant me title and he would be released of any liability.

I would lease the property for the amount of the payment for the first trust deed. (Every month Ipaid him $1153 and he wrote a check to the bank for the same amount.) In this way, the bank was not made aware that I had taken control of the property. I would also pay him the amount of the taxes owed twice a year, and also make payments equivalent to the insurance premium.

He added me to his insurance policy as an added insured because I was managing the property. There would be no transfer of tenant deposits. I would take over on the first of the month and start trying to collect whatever rents I could.

I would sign the papers and take control of the property if he would give me <u>$10,000 cash up front.</u>

What do you think the owner said when I told him he had to pay me $10,000 upfront for me to take over his property?

He couldn't get his check book out fast enough. He was losing almost $2000 per month if he did nothing. With my offer, he was going to stop the bleeding!

Was he taking a risk? Yes. I could have taken his $10,000, control of the property and bled it for a month. But he knew I was an established real estate broker who also owned several other properties and a management company.

SO HOW DID THE STORY END

Well, the first thing that I did was to get my maintenance and cleaning people into the vacant units and made them rent ready. I also determined which tenants would stay and which tenants had to go and either gave then notice to move or evicted them.

I also did some things to the exterior such as fencing some of the units. I next rented up the units with the best tenants that I could find and ended up with a property that created a nice positive cash flow. I never did formally assume the loan.

I owned the property for four years and then I decided to put it on the market. I advertised that financing was available based on 2-4 unit loans. When I had a buyer, we went back to the escrow company and opened a new second escrow. When it was time to close the escrow with the buyer, the escrow company paid the original owner's loan off and recorded a deed to me. Then, they closed the new escrow and deeded the property from me to the new buyer. I owned the property for just a few seconds.

Of course the old owner was happy to have the loan in his name paid off on the property and not have any more worries.

Besides the cash flow I had over the years, I received a check for **$219,559.10** at the close of escrow.

My yield during the time that I owned the K Street property was out of sight because I didn't have an initial investment in the property.

I actually took the proceeds and paid off my personal residence that I had owned for just a couple of years.

Why did this all have a happy ending? Well, to be honest with you, it was because I had some specialized knowledge that most buyers and agents don't have. First, I knew what it would take to fix up the property and manage the properly. Second, I had the knowledge to structure the transaction so that the whole process would work and it was win-win. Third, I knew how to sell the property with good financing.

This is an example of both a creative and a nothing down transaction.

This is why it is important that you either work with knowledgeable people or learn the information yourself.

ANOTHER EXAMPLE OF A SIMILAR TRANSACTION WITH ONE OF MY CLIENTS

Ann was a savvy investor who had owned property for years with a partner. After the partnership had dissolved she decided to purchase some property on her own. In the Multiple Listing Service, I found a 27-unit complex on McCray Street in Bakersfield that had been on the market for several months. The owner was in a mess that looked impossible to solve. The property had a non-assumable loan and so a purchaser would have to get a new loan. The property also had a lot of deferred maintenance including a few units that had roof leaks and needed new roofs. The owner did not have the money to fix the units up so that the property could qualify for a new loan. No one was willing to play all cash for the property.

I wrote an offer for Ann similar to my offer on K Street, a lease-purchase agreement. We agreed on a sales price for the property. Ann would put some money into escrow and take control of the property under the lease agreement. As she did the repairs, the bills were submitted to and paid out of the escrow so the seller knew that improvements were being completed. After a few months the repairs were completed and the property was now in condition that a new loan could be placed on it. The purchase was completed and Ann took title to the property. I got a very nice commission check.

*** **Please note that it is imperative that you get a title policy at the beginning of the lease period to make sure that there are no outstanding liens or judgments against the property. Also the owner of the property must indemnify the lessee – buyer that no liens or judgments will be added during the lease period.**

ANOTHER NOTHING DOWN TRANSACTION

In December, 1997, a man named Marshall called me to get together to discuss marketing two sets of properties that he owned, one with 5 units and the other with 7 units. Both the properties were in a decent bread and butter area.

When we met, Marshall stated that he owned both properties free and clear and that he wanted to do what is called an “installment sale” where he would carry a first trust deed with 10% down on each property. I already owned an 8 unit complex across the street from one of his properties. I did an appraisal of the properties and he felt that my numbers reflected a fair value for him.

Next, I had the following discussion with him. With 10% down he would net only around 2% of the sales price. He would be paying a 6% commission to me, closing costs and transferring tenant deposits to the buyer. He still felt comfortable because the buyer would be putting 10% cash into the property.

Next I told him that I was interested in purchasing his properties and that he would be smarter to sell the property to me for nothing down. The reasoning was that I had experience with rental property and it would be a safer risk to sell them to me than to a beginning investor that didn’t know how to manage the property. (I used the example of the owner of a restaurant selling it to someone who had never owned a restaurant compared to someone that owner several restaurants)

Marshall accepted my proposal and so this is what we did. We agreed to close escrow on January 2, 1998. I would escrow the property myself and draw up the grant deed and the note and trust deed. The sales price would be based on the agreed upon gross appraisal price less a 6% commission and the total of the tenant deposits. (He would keep them instead of giving them to me) My first payment was due 30 days after close of escrow and late after the 15th of the next month. I paid for the title policy, recording fees, and transfer tax. I collected the January rents which more than covered my costs of the purchase. I made the first payment with the February rents.

A year and a half later, Marshall called me again and wanted to do the same thing with a 20 unit that he also owned free and clear. I was a little leery of the area but after I did an interior inspection and saw the quality of the tenants, I felt comfortable enough to complete the transaction. We did exactly the same process as before.

As of this date, I still own all the units I purchased from Marshall and have actually paid them off. These are the 32 units that I own free and clear.

The moral of this story is that if you develop expertise and a track record in management, you have an advantage when making an offer involving owner financing.

CHAPTER 14
ANALYZING PROPERTIES

So far we have covered a lot of material. I hope you are understanding the different ideas that I have been sharing with you on how to build a real estate money machine. It's great to understand the ideas and the philosophies but none of it does any good unless know how to analyze a property. Your interest rate for a purchase might be 6% but if you can't find the cap rate pretty closely, you are back in speculator land.

We are going to try to make it as easy as possible to analyze a property by giving you a form to fill out called an Annual Property Operating Data form (APOD). Unfortunately, there are a lot of numbers that you need to be able to find to plug into the form. Some numbers can be very accurate. A few numbers will involve some guessing and this is what creates the risk. If we knew exactly what the cap rate was going to be for the year, there would be no risk at all. Even if we come up with accurate numbers for the property, the bottom line is how well the property is managed. Poor management can reduce a cap rate substantially.

I remember one year getting a call from an owner of a 25-unit complex located in a pretty good area of town on California Avenue. He was very motivated to sell. I got his income and expense statements from the management company and was amazed. His expenses without loan payments were greater than the property's income. In other words, if he owned the property free and clear, he had a negative cash flow. His net operating income was a negative number and when you divide a negative number by the purchase price of a property, you get a <u>negative cap rate</u>. Now, I don't know about other agents but selling an income property with a negative cap rate is pretty hard to do. The Art and Bill model is not looking so good.

Well, upon doing a little investigation, I found that the owner had no money to put into his management account. The management company was not keeping up with the maintenance and tenants were refusing to pay rent because their units were not being fixed. It was like a giant whirlpool sucking the property to the bottom of the ocean. In fact when I went out to look at the property, there was a camera crew from one of the T.V. stations interviewing tenants because they had organized and were having a tenant strike which even included signs.

So I had a pretty big challenge. The first thing I did was talk to the lender to see if they would be cooperative in solving the problem. The expressed some motivation to protect themselves. Next I met with one of my stronger buyers and I made an APOD for the property based on it being fixed up and managed correctly. After developing a plan, we made an offer. The lender agreed to allow the buyer to assume the loan and place funds in an escrow to repair the property. After all the work was completed and new management was in place, the buyer had a nice producing property.

The key to this transaction was analyzing the property after rehab to make sure the yield would be high enough to justify spending the money on the repairs. It was and I earned a really nice commission.

PROJECTING THE FUTURE

One of the interesting things that I seen over the years involve guru's and real estate agents that will do projections of returns on investment property for 5 – 10 years in the future or more. When I took classes from the National Association of Realtors® to obtain a CCIM designation (Certified Commercial Investment Member), we spent a lot of time on analytics, finding such things as the IRR (Internal Rate of Return) and FMRR (Financial Management Rate of Return). There are software programs designed to allow someone to put in some basic information and then print out an elaborate package of projections showing returns on a property for years to come to the nearest hundredth of a percent. WOW!

I just don't put much stock in the statement that for property XYZ in the tenth year of ownership, the return on investment will be 19.73%. No one is that good.

Even if the forms are printed on colored paper with a nice font, my personal belief is that they are not worth the paper they are printed on.

This would be information attractive to a speculator, not an investor.

I don't try to calculate into the future because:

1. I think you are not being honest with the client, and
2. I don't want to have the liability of the owner coming back several years later and stating that his yield was only 13.29%, not 19.73% and he wants to sue me even though it stated in real little print at the bottom of the projections that these were only estimates.

Who can really project the increase of income, expenses and appreciation over any length of time? If I could, I would be a lot richer that I am now.

"One of the reasons there is so much bad financial information is simply because it does not take much education or training to become a licensed financial authority. If fact, in many places, it takes longer to become a licensed massage therapist that it does to become a licensed financial advisor. Financial intelligence is having control over your cash flow. As we compare investing for cash flow with investing for capital gains, we must recognize the information we're using in making those decisions. In analyzing an investment for cash flow, you look at the current information and decide based on the current net cash flow. <u>FACT!</u> In analyzing for capital gains, you typically invest in something that you believe, or have been told, will increase in value over time. <u>OPINION!</u> – Rich Dad

WHAT I FEEL I CAN COMFORTABLY PROJECT

As far as projecting into the future, I feel comfortable taking an APOD, (Annual Property Operating Data) Form, placing what accurate information is available, and estimating those variable costs for the **1st year of ownership**. I predict vacancy and maintenance costs based on the age and condition of the property and my years of experience managing comparable property. (If you don't have the experience, get information from appraisers, management companies, and knowledgeable real estate agents and then be prepared that it probably will still be off some.)

I believed it is important to do a one-year projection to give a buyer a way of comparingproperties that are for sale today. My goal is to lay out side by side our one year estimates forseveral properties to determine which one makes better sense.

About the only thing I can tell a buyer about the future is what the loan balance will be if they make all their payments and don't refinance the property. I can't tell a buyer that in ten years, what the market rents, vacancy factor, expenses, changes in tax laws, property taxes and insurance rates, new required building codes, appreciation rate, or any other projection.

Chances are good that if I analyzed 5 different properties today and ranked them in order or return, and then applied the same rates for appreciation, rent increase and expenses to each over a 10 years period, the rankings would remain the same.

It ended up that I knew I would use very little of the information I was being taught in the CCIM classes, and for that reason, I did not complete the requirements necessary to get my designation.

It is my opinion that if an agent tries to sell you a property based on long term projections, it is probably a smart idea to look for another agent who deals in the real world today.

WHAT ARE WE REALLY BUYING WHEN WE PURCHASE AN INCOME PROPERTY?

As we have explained earlier, there are two types of assets, net worth assets and cash flow assets. When an individual purchases a net worth asset, he is doing it with the hope that the asset will appreciate in value. **His goal is to buy low and sell high.**

An investor who purchases a cash flow asset is purchasing an asset that generates an income stream. There are two kinds or income – gross income and net income. When I first started to invest, a common way to price a piece of rental property was to look at comparable property that had sold, determine the gross rent multiplier (GRM), and then multiply that gross rent multiplier to the gross income for property I was appraising.

Example: A fourplex generates a gross yearly income of $18,000 per year. It sells for $148.500. The gross rent multiplier would by 148,500 ÷ 18,000 = 8.25.

Example: Several similar properties in an area have sold for between 6.75 and 7 gross rent multipliers. A similar property on Berry Street is listed that has a gross income of $24,300. The value of the Berry Street property would be between $164,025 (6.75 X 24,300) and $170,100 (7 X 24,300).

Example: Sometimes, you can see a pattern of similar units selling for so much per unit or so much per square foot. At one time in East Bakersfield, 2 bedroom units were selling for $30,000 per unit and 1 bedroom units were $25,000 per unit.

I use to see rental properties advertised for sale in the paper where the agent would include the **gross rent multiplier** as part of the information.

The gross rent multiplier is O.K. to start with, but it is very crude and more analysis should be done. For instance, Berry Street might have the tenant's gas and electricity included in the rents. It might rent furnished, and allow pets where the other comparables did not. Berry Street may be in excellent condition with no deferred maintenance while the other properties are in poor condition. You want to make sure you are comparing apples to apples and oranges to oranges.

A better measurement to use is to first find the Net Operating Income, then the Cap Rate. This number is determined by finding the annual gross rental and other income, subtracting a vacancy factor and all of the annual expenses except a mortgage payment. Remember, Cap Rate is the rate of return if you owned the property free and clear.

Example: Cherry Street creates $45,600 gross rental income plus $1150 laundry room income. The vacancy factor in the area is 4.5%. The expenses for the year including management fees are $17,328.

To determine the Net Operating Income we would first multiply $45,600 X .045 = $2052 to obtain the vacancy loss.

Next we subtract the $2052 from $45,600 to obtain a Gross Operating Income of $43,548.

Then we subtract the expenses from the GOI, $43,548 - $17,328 and that gives as a **Net Operating Income** of $26,220.

The Net Operating Income is divided into two parts – first it goes to pay the mortgage and then whatever is left over is cash flow.

To find the cap rate you use the formula:

CAP RATE = Net Operating Income (NOI) ÷ Sales Price

REMEMBER OUR GOAL – Use the Art and Bill Model to purchase property. Let's say we can get a real estate loan on the property for 7% interest. We will also assume that we want to get a cap rate of 9.5 % so that we are making 2.5 % on the borrowed money. To determine the price we will want to offer, we divide the NOI ($26,220 by the cap rate 9.5% (.095) and we get a price of $276,000.

Now suppose the property is for sale for $350,000. What is the cap rate based on that price?

Cap Rate = $26,200 ÷ $350,000 and we get 7.49%

We are still making money with Art and Bill but it is not giving us our desired cap rate and yield. We have two choices. Make a lower offer or forget about the property and move on to the next one.

ANALYZING A PROPERTY

"How can you expect to find a great investment if you first don't know what a great investment looks like and you're not willing to invest the time to look for the investment? The worst investments go to the impatient investors." – Rich Dad

Goal #1 – Find out the information we need so that we can analyze the property as accurately as we can.

Goal #2 – Using our analysis, write an offer that will give us the opportunity to receive the <u>most benefits</u> that we can from the seller and will cause us to receive at least the minimum yield that we want.

Your real estate agent has given you a list of properties in different areas that are for sale and you have gone by the outside and gotten a feel for what is available. You tell your agent that there is one property that really looked interesting at 987 Center Street and you want him to find out more information about the property.

A smart residential income agent will not only ask for particular information about the property, he will also try to find out some important details about the seller.

Let me tell you what I do for my clients.

The first thing I would do is call the listing agent. Now, if you will remember, the listing agent has a fiduciary duty to the seller but still must be honest with us. I also have a fiduciary duty to the buyer but must be honest with the seller. Both agents should also realize that they need to cooperate with each other in order to successfully close an escrow. I would ask the questions I gave you on page 136.

Once I have established that the property is still for sale and have heard the agent's reason the seller is selling the property, I do a couple of more actions.

1. Call my title company and order a property profile for the property. From this I can tell such things as how long the seller has owned the property, the assessed value of the land and improvements, the current amount due for the taxes, the lot size and if the property is on one or more parcels. In most cases, I can determine the price the owner paid for the property and when he purchased it. The title company can also tell me if there is a notice of default filed on the property. (A recorded declaration from a lender stating that the owner has defaulted on the loan and may lose it in foreclosure.)

2. Get a copy of the tax bill from the tax collector. (Usually this can be done on the Internet.) Sometimes there is more information on the property tax bill about the physical characteristics of the property. Also, check with the property tax collector to make sure that the taxes are current. (It would be very important to know if the property is tax-defaulted.)

All of this information is public domain and you as a potential buyer may also obtain this information for free.

I don't remember where I read it, but there is a statement, "Know thy enemy!" Now the seller and the listing agents are not really the enemy but the more we know about them, especially the seller, the better we can design our offer to our benefit.

THE APOD
ANNUAL PROPERTY OPERATING DATA FORM

This is where the rubber meets the road. Our goal is to Win the Game of Money applying the Art and Bill model by purchasing high yielding cash flow properties. So how do we know if a property will give us a good yield and a positive cash flow? **The answer is we have to analyze it.** The best way to do this is to use some type of form where we can write down all the income and expenses for a property. Most knowledgeable real estate agents use a form called and Annual Property Operating Data Form (APOD). A large percentage of the agents in your area have never heard of an APOD.

Remember, you want to be in a position where you don't have to trust other people. You especially don't want to take advice from poor people and sales people. You also want to place experts into your mastermind group that can help you reach your goals in a win-win situation.

Let's say you have decided to invest in a multi-family property and you want to determine what information is needed to try to have as accurate an analysis as you can. I've tried to show how important this is if we want to apply the ART and BILL model.

We'll take some time doing an example which pretty much can be applied to any residential income property.

I will divide the APOD into 7 distinct areas and we will discuss each area individually.

Annual Property Operating Data

Name ____________________

Location ____________________

Type of Property ____________________

Size of Property ____________ ☐ Sq.Ft. ☐ Units

Purpose:

☐ Owner's Statement ☐ Broker's Forecast
☐ Existing Financing ☐ Potential Financing
☐ Seller's Position ☐ Buyer's Position

Assessed / Appraised Value

Land	$		%
Improvement	$		%
Personal Property	$		%
Total	$		100 %

Adjusted Basis as of ____________ $ ____________

Date ____________________

Price $ ____________________

Existing Loan ____________________

Equity ____________________

Existing	Balance	Payment	#Pmts/Yr.	Interest	Term
1st	$				
2nd	$				
3rd	$				
Potential:					
1st	$				
2nd	$				

1, 2, 3, 4, 5, 6, 7

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME					
2	Less: Vacancy & Cr. Losses			% of $ ____)		
3	EFFECTIVE RENTAL INCOME					
4	Plus: Other Income					
5	GROSS OPERATING INCOME					
	OPERATING EXPENSES:					
6	Real Estate Taxes					
7	Personal Property Taxes					
8	Property Insurance					
9	Off Site Management					
10	Payroll - Onsite Personnel					
11	Expenses / Benefits					
12	Taxes / Worker's Compensation					
13	Repairs and Maintenance					
	Utilities:					
14						
15						
16						
17						
18	Accounting and Legal					
19	Real Estate Leasing Commissions					
20	Advertising / Licenses / Permits					
21	Supplies					
22	Miscellaneous					
	Contract Services:					
23						
24						
25						
26						
27						
28						
29	TOTAL OPERATING EXPENSES					
30	**NET OPERATING INCOME**					
31	Less: Annual Debt Service					
32	**CASH FLOW BEFORE TAXES**					

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Prepared by ____________________

FORM APO-11

PARTS OF THE APOD

It is important to become familiar with an APOD, what we are trying to find and how the numbers are applied to come up with the most important number in our analysis, **THE CAP RATE.**

PART 1

Name ______________________

Location ______________________

Type of Property ______________________

Size of Property ____________ ☐ Sq.Ft. ☐ Units

Purpose:

☐ Owner's Statement ☐ Broker's Forecast

☐ Existing Financing ☐ Potential Financing

☐ Seller's Position ☐ Buyer's Position

Assessed / Appraised Values

Land	$ ________	________ %
Improvement	$ ________	________ %
Personal Property	$ ________	________ %
Total	$ ________	100 %

Adjusted Basis as of ____________ $ ____________

In the first section of the APOD form, we will use the tax bill for the property to determine two things:

1) The current assed value for the property.
2) The percentage of the value of the property that is allotted to improvements

We will use these numbers for two reasons:

1. To determine what the new reassessed taxes will be for the property.
2. To determine the amount of depreciation we can claim against the property each year.

PART 2

Annual Property Operating Data

Date ____________________

Price $ ____________________

Existing Loan ____________________

Equity ____________________

Existing		Balance	Payment	#Pmts/Yr.	Interest	Term
1st	$					
2nd	$					
3rd	$					
Potential:						
1st	$					
2nd	$					

This section of the APOD is primarily designed to list the existing and new purchase loan information. In some cases the existing loan information will be on the listing or can be obtained from the listing agent to see if it is worth working with. The seller's equity may also be important to know.

PART 3

COMMENTS/FOOTNOTES

This is where I record the individual rents for the units so that my client can see what each apartment rents for. Then I add them to get the gross monthly income. If the rents are not at market, you may want to substitute a projected rent instead.

PART 4

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%		
1	POTENTIAL RENTAL INCOME	______	______		______
2	Less: Vacancy & Cr. Losses	(______ % of $ ______)			______
3	EFFECTIVE RENTAL INCOME	______	______		______
4	Plus: Other Income	______	______		______
5	GROSS OPERATING INCOME	______	______		______

Here we want to determine the Gross Operating Income. We start with the current or potential rents for the units, subtract for vacancy and credit losses, add any additional income such as from a laundry room and this should give us our gross income, the income we would put into our checking account for the year.

PART 5

	OPERATING EXPENSES:			
6	Real Estate Taxes	____	____	______
7	Personal Property Taxes	____	____	______
8	Property Insurance	____	____	______
9	Off Site Management	____	____	______
10	Payroll - Onsite Personnel	____	____	______
11	Expenses / Benefits	____	____	______
12	Taxes / Worker's Compensation	____	____	______
13	Repairs and Maintenance	____	____	______
	Utilities:			
14	______	____	____	______
15	______	____	____	______
16	______	____	____	______
17	______	____	____	______
18	Accounting and Legal	____	____	______
19	Real Estate Leasing Commissions	____	____	______
20	Advertising / Licenses / Permits	____	____	______
21	Supplies	____	____	______
22	Miscellaneous	____	____	______
	Contract Services:			
23	______	____	____	______
24	______	____	____	______
25	______	____	____	______
26	______	____	____	______
27	______	____	____	______
28	______	____	____	______
29	TOTAL OPERATING EXPENSES	____	____	

This section is where we try to estimate the expenses as closely as we can. Once you have done a few of these, it gets a lot easier because you have a better knowledge of the all the numbers.

On the next page is a PART 5 where I explain some of the categories in a little more detail. We will go into more detail on how to find these numbers later in this chapter.

6	Real Estate Taxes	____________	Calculate from tax bill
7	Personal Property Taxes	____________	Usually not applicable
8	Property Insurance	____________	Quotes from insurance companies
9	Off Site Management	____________	Professional management costs
10	Payroll – Onsite Personal	____________	Resident manager
11	Expenses/Benefits	____________	Resident manager
12	Taxes/Worker's Compensation	____________	Resident manager
13	Repairs and Maintenance	____________	
	Utilities		
14	Water	____________	
15	Gas/Electricity	____________	
16	______________________	____________	
17	______________________ Accou	____________	
18	Real Estate Leasing Commissions	____________	Tax preparation and evictions
19	Advertising/Licenses/Permits	____________	Usually not applicable
20	Supplies	____________	Advertising cost, Pool permit, etc.
21	Reserves for Replacement	____________	
22		____________	For large items like roof or air conditioning, heating
	Contract Services		
23	Yard Care	____________	
24	Pest Control	____________	
25	Trash	____________	
26	Pool Service	____________	
27	______________________	____________	
28	______________________	____________	
29	TOTAL OPERATING EXPENSES		_______________

PART 6

30	**NET OPERATING INCOME**	____ ____	________

All this effort is designed to find this number, the **NET OPERATING INCOME**, the income that would be generated if we owned the property free and clear. It is used to determine the **CAP RATE** for the property.

PART 7

31	Less: Annual Debt Service	________
32	**CASH FLOW BEFORE TAXES**	________

This is where we subtract the yearly loan payment from the net operating income to come up with what our cash flow in our checking account would total for the year. We are not taking into effect the tax consequences of ownership of the property at this time.

The second most important number is the CASH FLOW BEFORE TAXES. Of course, if the cap rate is greater than the interest rate (Art and Bill), this number will always be positive.

FINDING THE NUMBERS FOR YOUR APOD

Probably in your city there are different areas. Some have newer, nice pride of ownership units that appeal to white collar workers. These may have extra amenities such as a fire place, washer/dryer hookups, garages, private yards, and being close to schools, shopping, and transportation.

Another area may have older units, may have fewer amenities but still be appealing to blue collar workers.

And then you may have less desirable areas that attract low income tenants who may be on social security, welfare, or Section 8.

First we need to find the market rents and vacancy rates are for the specific type of property you are interested in! Let me list 6 methods for you:

1. First is to check your local newspaper in the “Apartments For Rent” section. Look for units that are similar to the properties that you are interested in. Check the location, number of bedrooms, baths, and other amenities.
2. Call management companies in your area and ask them for their opinion for the type of units you are interested in. They may even provide you with a list of the units they manage and the rents or a list of vacancies that they may have. You should get to know the owners of these companies because they can be very valuable to you, providing information on quality of tenants, expenses for the units, and trends for the neighborhood.

3. The Multiple Listing Service for the Local Board of Realtors®. In most cases, you can find the MLS on the Internet. Listed would be units for sale and these would include the rents placed in the listing. You should be very careful here. Some agents will list the actual rents like they are supposed to but other agents will list what they feel are the “Market Rents” which can have an effect on the offer you write on that property. Sometimes the vacancy rate, expenses, existing loan information and cap rate are listed. Unfortunately, in some cases these numbers will be incorrect because the agent projects them instead of getting the actual numbers for the owner. Even if the agent gets numbers from the owner, the owner could have “fudged” to make them look better.
4. Knowledgeable real estate agents who specialize in residential income property sales. They are going to know about areas, income, and expenses. In most cases, they would be happy to answer your questions to try to impress you to work with them.
5. A really good source of information is local appraisers who work with rental properties. They need to know income, vacancy, and expense information in order for them to do the income approach appraisal. In Bakersfield, we had an appraiser who researched the management companies and issued a nice report every 6 months showing the vacancy number by areas and number of bedrooms.
6. Apartment Owners Associations and owners that you meet that own units.

Some expenses can be very accurately determined. Others involve some research and analysis.

- **Taxes** – tax information on any property is available to the public. Call your county tax collector or tax assessor to find out what the value of the land, improvements, personal property and total assessed value is. Then ask for the total taxes owed. Sometimes, it is a good idea to get a copy of the tax bill. You will often see the assessed taxes for the property itself, and then all of the additional taxes added on such as for schools, sewer, special assessments, etc. Remember, when you purchase the property, it will be re-assessed and the property taxes could go up significantly.
- **Insurance** – When I first started investing, I did a lot of shopping around to find which companies insured rental properties and then who had the most affordable rates.
- **Offsite management** – If you use professional management, make sure you read my book, “How to Manage Residential Income Property for Maximum Profit” where I explain how to find an honest company that looks out for you. Get a quote on all the charges that they have.
- **Water** – call the water district that the units are located in. Ask them if the property is charged on a fixed per/unit cost or if there is a meter. They can give you numbers for the fixed cost or give you several months of metered costs so that you can get an average.
- **Gas and Electricity** – some properties either pay for the tenants utilities or may have a meter for exterior lights and/or laundry room.
- **Accounting/Legal** – If you have someone do your books or taxes find out their cost. Legal mainly involves evictions and small claims actions.
- **Advertising** – call your local newspaper and get a quote to run an ad each day.
- **Supplies** – this is mainly things like air conditioning/heating filters and light bulbs.

- **Reserves for Replacement** – this category is usually overlooked by most agents. You need to save money each month for big ticket items such as roof replacements, new appliances, heating and cooling equipment.
- **Yard Care** – in my area, gardeners are a dime a dozen. You have individual people who have their own route versus large companies with dozens of employees. Get lots of quotes.
- **Pest Control** – I advise you to have monthly service – get a quote
- **Trash** – my experience is that some properties have the cost of trash included in the property taxes. Others have a fixed monthly or quarterly bill. This is very easy to find out with a few calls. For some properties, you will need to have a dumpster installed on the property. On other properties, trash cans will work.
- **Pool Service/Snow Removal** – get quotes is applicable.

THE TOUGH NUMBERS TO DETERMINE

- **Vacancy** – In just about every listing or APOD that I see, the agent uses 5%. Vacancy really means more than the time a unit is unoccupied. It also means time when the unit is occupied but the tenant is not paying rent (Credit loss). Sometimes you have to solve this problem by doing an eviction. Sometimes the tenant just moves out in the night owing money. Sometimes you can get them out with Cash for Keys (See my book, How to Manage Residential Income Property for Maximum Profit). Sometimes you will be able to come out OK if the tenant's deposit will cover all your costs. The bottom line, this number can be large and even larger if you are a poor manager. The best way to approximate this number is by using the same resources that we taught you for finding the market rents above.
- **Maintenance costs** – if you think estimating a number for vacancy is tough, maintenance can be even tougher. There are two philosophies owners have about maintenance, (1) they do it themselves or (2) they hire someone else to do it. It took me about a year to figure that I sucked trying to repair anything and it was smarter for me to hire others. In fact I tell people that the only tool that I want to own is a "toe nail clipper." Tenants can be rough on the property because they do not own it. Things break. Look at the owner's or management company's income and expense statement for the property. Have an inspection done and have the inspector tell you what type of economic life the existing roof and appliances might have. Estimate high for this maintenance costs just to be safe.

INFORMATION TO ORDER
OR RESEARCH IMMEDIATELY

1) PROPERTY PROFILE – order from a title company – you will need the parcel number or physical address.

2) TAX BILL ON THE PROPERTY – the Tax Assessor has this and it is public domain (Anyone can look at it.) You will need the parcel number or physical address. In some cases, it can be found on the Internet.

LET'S LOOK AT ANOTHER PROPERTY PROFILE

The Property Profile contains 4 parts.

PART 1 OWNERSHIP INFORMATION

In this section, the name or the owner, property address, and mailing address can be seen. I have deleted them in this example.

Property Profile	
Ownership Information	
Primary Owner	
Secondary Owner	
Ownership Description	
Site Address	
Site City, St Zip	
Mail Address	
Mail City, St Zip	
Telephone	
Census Tract	0028.17
Legal Description	TRACT 3882 LOT 55
Lot/Block	55/
Housing Tract / Subdivision Name	3882

PART 2 PROPERTY DETAILS

In this section, you can sometimes find more information about the property. Here you can see that the property is a fourplex, built in 1978, one story, 3432 square feet, has a garage, 9 total bedrooms, and 4 ¾ baths.

Property Details			
Use Description	QUADRUPLEX		
State	CALIFORNIA	**County/Municipality**	KERN
RTSQ		**Total Rooms**	
Zoning		**Bedrooms**	9
Number Of Units	4	**Bathrooms**	4.8
Year Built/Effect Yr Built	1978 / 1978	**Basement Square Feet**	
# Of Stories	1	**Basement Description(s)**	
Lot Size		**View**	
Usable Lot Size		**Pool**	
Lot Depth		**FirePlace**	
Lot Width		**HT/AC**	HEATING
Square Feet	3,432	**Cooling Detail**	
Square Ft 1st Flr	3,432	**Heating Detail**	FORCED AIR
Square Ft 2nd Flr		**Roof Type**	
Square Ft 3rd Flr		**Construction Quality**	6
Additions - Square Feet		**Construction Type**	WOOD FRAME
Parking	Garage	**Exterior**	
Parking Square Feet	612	**Foundation**	
New Page Grid		**Building Shape**	
Map Page Grid			

PART 3 TAX INFORMATION

This part of the profile shows the Parcel number, the Assessed Value for the land, improvements, and total, the percentage allotted to the improvements, 86%, the current tax amount owed and that the taxes are current.

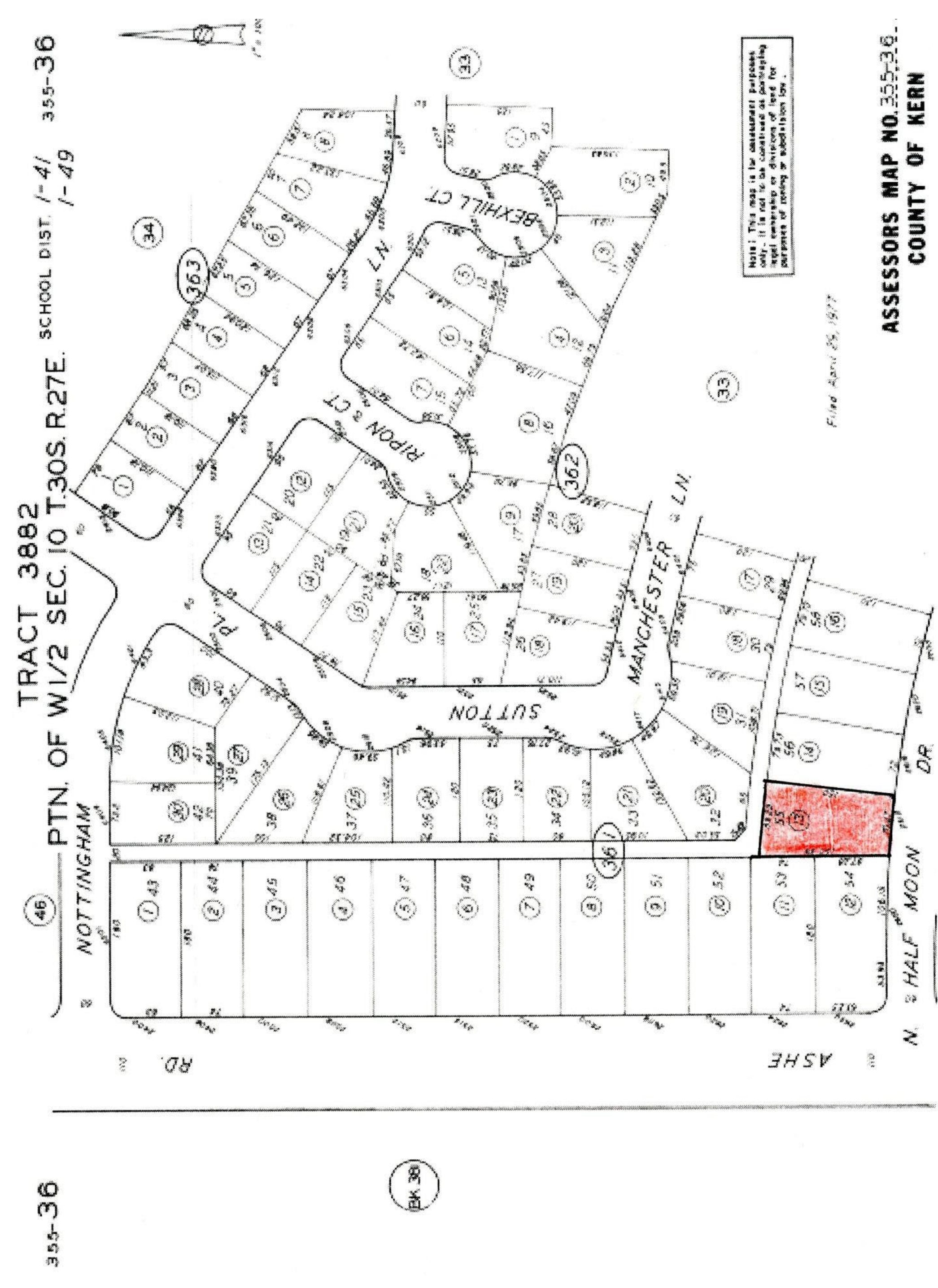
Tax Information			
Assessor's Parcel Number / Tax ID	355-361-13-00	**Assessor's Market Value**	$0
Alt Assessor's Parcel Number		**Exemption**	
Assessed Total	$206,320	**Tax Amount**	$3,375.45
Land Total	$29,689	**Tax Status**	Current
Improvement	$176,631	**Year Delinquent**	
Percent Improvement	86%	**Tax Rate Area**	1041

PART 4 SALE INFORMATION

In some cases, you will be able to find out what the previous owner paid for the property and when it was purchased. You can see that this shows the last sales date was August 1 2002. But in December 2005, it shows sale value $440,000 and 1st Loan Mount $440,000. It looks like they did a refinance in 2005. We cannot tell the original purchase price for the owner. However, a good title officer may be able to determine it by going through previously recorded information. By the way, this property is now worth about $215,000 and the owner has a real problem.

Sale Information			
Last Sales Date	August 1, 2002		
Document Number	0000122229	**1st Loan Amount**	$440,000
Sale Value	$440,000 (Full)	**First Loan Type**	Conventional
Last Transaction W/O $	December 30, 2005	**2nd Loan Amount**	
Last Transaction W/O $ Doc	0000360666	**Cost / Square**	
feetTitle Company	STEWART TITLE		

Most Property Profiles will also include a parcel map with it.



FOUR PARTS TO THE TAX BILL

EXHIBIT ONE

ASSESSMENT INFORMATION

Assessment Information for Tax Year	2010-2011
	Assessed Values
Land Value:	29,679
Mineral Value:	0
Improvement Value:	176,641
Other Improvement:	0
Personal Property Value:	0
Total:	206,320
Less Exemption Value:	0
Net Total Taxable Value:	206,320
Tax Rate Area:	001-041 BAKERSFIELD INSIDE-PANAMA

There are usually four parts to the tax bill that can provide you with valuable information. The first part tells you what value the tax collector places on the property. This is important for several reasons.

First of all, the Net Total Taxable Value has absolutely no relationship to what the true value of the property is at this time. The Net Total Taxable Value is determined by the value of the property at the time of the last sale which occurred in March 1998 and adding 1% of the value each year for appreciation. This is based on Proposition 13 which was passed in California to limit how much taxes the state could collect. It will be different if you live in a different state.

You can see that there are no values given for “Mineral Value,” “Other Improvements” and “Personal Property Value.”

We are going to determine some ratios for our APOD. The first is the percentage of the value of the land to the value of the property. To find the percentage of land value, we divide the land value by the total value.

Land Value ÷ Total Value = 29679 ÷ 206320 = **14.38%**

The second ratio is the percentage of the value of the improvements to the value of the property.

Improvement Value ÷ Total Value = 176,641÷ 206320 = **85.62%**

For our APOD we will round these numbers to 14% and 86%. And place them in Part One of the APOD.

Name Serious Buyer -

Location 934 Center Street

Type of Property 4-plex

Size of Property ________ [ ] Sq.Ft. [5] Units

Purpose

[ ]	Owner's Statement	[X]	Broker's Forecast
[ ]	Existing Financing	[ ]	Potential Financing
[ ]	Seller's Position	[ ]	Buyer's Position

Assessed/Appraised Values

Land	**$ 29,679**	**14 %**
Improvement	**$ 176,641**	**86 %**
Personal Property	$________	________%
Total	**$ 206,320**	**100 %**

EXHIBIT TWO
TAX BILL INFORMATION

Tax Bill Information

Questions regarding tax bills should be directed to the Tax Collector at (661) 868-3490.

Lien Date Bill		09-1256335-00-4		Paid
Net Billed Value		**Tax Rate Area**		**Proration Period**
206811		001-041		1 Year
General Amt	**Special Amt**	**Special Asmnts**	**General Rate**	**Special Rate**
2,321	0	1,054	1	0

	Due Date	Amount	Date Paid	Penalt	Total Paid
1st Installment	12/10/09	1687.73	12/07/09	0.0	1687.7
2nd Installment	04/12/10	1687.72	03/30/10	0.0	1687.7
Total		3375.45			3375.45

Exhibit Two, the Tax Bill Information shows us that the total tax owed for the year for the property with an assessed value of $206,811 is $3375.45. If I used this figure in my APOD, it would be inaccurate because the property will be reassessed by the Tax Collector when the escrow closes and in most cases, the assessed value will be raised to the new sales price.

To determine the new property taxes on the property, we should look at **Exhibit Three**, the **Tax Bill Detail**.

EXHIBIT THREE
TAX BILL DETAIL

Tax Bill Detail			
Fund No	**Taxing Agency**	**Rate**	**Amount**
00280	GEN LOCAL GOVT	1.000000%	2068.15
60229	KCWA ZN 7 DEBT	0.033188%	68.6
60239	KCWA ZN 17 DEBT	0.010943%	22.6
60241	KCWA ZN 19 DEBT	0.015953%	32.9
70664	PANAMA 2002 REF	0.009889%	20.4
71041	KHS REFUNDING 96A	0.016255%	33.6
71042	KERN HIGH 1990E	0.003006%	6.21
71043	KERN HIGH 2004A	0.007257%	15.0
71044	KERN HIGH 2004B	0.010605%	21.9
71045	KERN HIGH 2004C	0.005991%	12.3
76962	KCCD SRID 2002A	0.002379%	4.92
76963	KCCD SRID 02A RFD	0.005756%	11.9
76964	KCCD SRID 2002B	0.001266%	2.61
20116	BKFLD SEWER PLT 3		731.4
24150	*KCSWMP LAND USE		299.3
42317	KMVCD VECTOR ASMT		2.00
78038	KCCD ASSMT DIST		21.3
	Total	1.122488%	3,375.45

As you can see, there are several items listed that are added together to get the total tax bill for the property. The first is 00280, GEN LOCAL GOVT, which is 1% of the assessed value. Others are based on a percentage of the assessed values such as bonds that were passed for schools and water districts. If you look at 71043, KERN HIGH 2004A, you will see that 0.007257% of the assessed value is charged for the item. You will also see some items that are not based on a percentage, but are instead a fixed amount such as 20116, BKFLD SEWER PLT 3, $731.43.

At the bottom of the chart, you will see the Total of the Rates 1.122488% and the total tax bill, which is $3375.45.

To determine our new taxes for the new purchase price of $275,000, follow these steps.

1) Add up the fixed amounts, Nos. 20116 thru 78038.

$731.43 + 299.30 + 2.00 + 21.30 = **$1054.03**

This number will be the same no matter what the purchase price.

2) Find the total percentage rates for the variable taxing agencies. This is the % number in the total column. In this case it is **1.122488%.** Convert this number to a decimal by moving the decimal point two places to the left. We now have **0.01122488**. Multiply this number times the sales price.

0.01122488 X 275,000 = **$3086.84**

3) Add these two numbers together to get the new tax bill.

$3086.84 + $1054.03 = **$4140.87**

APOD

6	Real Estate Taxes	**$4141**
7	Personal Property Taxes	____________
8	Property Insurance	____________
9	Off Site Management	____________

A couple of things you should know as an investor about taxes.

1. In California, the taxable year for property taxes goes from July 1st to June 30th. You bill is divided into two payments. You first half bill is due by December 10th and your second half bill is due by April 10th.
2. When you close escrow, the escrow company will prorate the taxes based on the old tax bill. You will either pay or be credited for your prorated part depending on the time of year and whether the owner has paid for his share or not.
3. You will receive a supplemental bill from the tax collector for the additional amount you will owe for the current tax year.
4. In some cases, your lender may require that you establish an **impound account** with them, where you make additional payments towards your taxes and/or insurance. They make these payments for you so they know for sure that they taxes and insurance are being paid.

Example: I have a loan on two houses on one lot. My principal and interest payments are $583.57 per month. I pay an additional $197.17 per month that is put in my impound account to pay taxes and insurance. My total payment is $780.74 per month. As the taxes and insurance go up, the bank adjusts the monthly impound payment so that it will collect enough to pay the taxes and insurance when they are due.

TAX CONSEQUENCES

The second reason for finding the assessed value numbers has to do with figuring out the tax benefits from owning the property. As we saw the tax collector assessed the improvements as 86% of the value of the property. If you want to be more aggressive, you can try to increase this number even higher. The challenge is if your number does not make sense to the IRS, you are likely to be audited. If you use the 86% number, the IRS will probably have no problems because you are just using the tax assessor's numbers.

The first computation we will make is to determine the value of the improvements of the property. We find this number by multiplying the improvement percentage times the sales price (or new assessed value of the property.)

.86 X $275,000 = $236,500

The depreciable life for the property is 27.5 years. To determine the amount of depreciation for each year, we would divide the improved value of the property by the depreciable life:

$236,500 ÷ 27.5 = $8600 per year.

This number represents the amount of paper loss we are allowed each year for the property depreciating in value. When you prepare the taxes for this property each year, you will fill out a tax form (Schedule E) which is similar to an APOD but you are using your actual numbers performed by the property for the year. You will put down your income and your expenses, which will give you your cash flow for the property. However, you will also enter the $8600 depreciation as an expense for the property. If your total loss on the property is greater than your total income, you have a taxable loss which can be subtracted from your ordinary income, therefore reducing your total taxable income and your taxes owed. (Talk to you accountant if you need more explanation.)

EXHIBIT FOUR

PROPERTY CHARACTERISTICS

Property Characteristics
Bldg#1 - AC Type : PACKAGE
Bldg#1 - Class of Construction : D6.5
Bldg#1 - Gross Building Area : **4,163**
Bldg#1 - Heat Type : GAS
Bldg#1 - Landscaping : FAIR
Bldg#1 - Laundry : YES
Bldg#1 - No. of Buildings : 1
Bldg#1 - No. of Stories : 2
Bldg#1 - No. of Units : **5**
Bldg#1 - Original Year Built : **1979**
Bldg#1 - Parking Type : GARAGES
Bldg#1 - Property Condition : GOOD
Bldg#1 - Quality : GOOD
Bldg#1 - Roof Cover : COMP
Bldg#1 - Roof Type : GAB
Bldg#1 - Unit Type A - No. of Baths : 1
Bldg#1 - Unit Type A - No. of Bedrooms : 2
Bldg#1 - Unit Type A - No. of Rooms : 4
Bldg#1 - Unit Type A - No. of These Units : 4
Bldg#1 - Unit Type A - Unit Description : 2BR1BA
Bldg#1 - Unit Type B - No. of Baths : 2
Bldg#1 - Unit Type B - No. of Bedrooms : 3
Bldg#1 - Unit Type B - No. of Rooms : 5
Bldg#1 - Unit Type B - No. of These Units : 1
Bldg#1 - Unit Type B - Unit Description : 3BR2BA

This can give you more information about the physical characteristics of the property. You can see that this property has 4,163 square feet (This does not include any square footage for the garages.) We can also see that there are 5 units, 4 units are 2 bedroom 1, and one is 3 bedrooms, 2 baths. The roof is composition shingle.

CASE STUDY – 212 EL TEJON – 2 HOUSES ON ONE LOT – SALES PRICE $85,000

The first thing we shall do is get a copy of the tax bill or a property profile. I have a copy of the tax bill and under property characteristics we can see that one house was built in 1938, has 2 bedrooms and 1 bath and 900 sq. ft. The second house was built in 1970, also has 2 bedrooms and 1 bath, and 864 sq. ft. The square footage of the structures is needed to get an accurate quote for insurance.

Property Characteristics Array	
Unit 1	
Year Built	1938
Sq. Ft.	900
Bed / Bath	2/1
Unit 2	
Year Built	1970
Sq. Ft.	864
Bed / Bath	2/1

Under Assessment Information you can see that the Land Value is 12,612, Improvement Value is 45,418, and Total is 58, 030.

Assessment Information for Tax Year	2010-2011
	Assessed Values
Land Value:	12,612
Mineral Value:	0
Improvement Value:	45,418
Other Improvement:	0
Personal Property Value:	0
Total:	58,030
Less Exemption Value:	0
Net Total Taxable Value:	58,030
Tax Rate Area:	121-015 STANDARD

On the APOD, in Section 1 we would place these numbers and then to determine the percentages, we would divide the Land Value by the Total Value and the Improvement Value by the Total Value.

12,612 ÷ 58,030 = .2173 = **22%**

45,418 ÷ 58,030 = .7827 = **78%**

Part 1 of our APOD would look like this:

Name ______

Location 212 ELTEJON

Type of Property TWO HOUSES ON 1 LOT

Size of Property 1764 ☒ Sq.Ft. ☐ Units

Purpose:

☐ Owner's Statement	☐ Broker's Forecast
☐ Existing Financing	☐ Potential Financing
☐ Seller's Position	☒ Buyer's Position

Assessed / Appraised Values

Land	$ 12,612	22 %
Improvement	$ 45,418	78 %
Personal Property	$	%
Total	$	100 %

Adjusted Basis as of ______ $ ______

Moving to Part 2 of the APOD, the main information we will need is the terms for a new loan. In this case, we are told that we can get an 80% loan-to-value at 6.5% fixed for 30 years. Based on a sales price of $85,000, we can get a loan for $68,000 which gives us a payment of $429.81. Our down payment will be $17,000.

Annual Property Operating Data

Date ______

Price $ 85,000

Existing Loan ______

Equity ______

Existing	Balance	Payment	#Pmts/Yr.	Interest	Term
1st	$				
2nd	$				
3rd	$				
Potential:					
1st	$ 68,000	429.81	12	6.5	360
2nd	$				

DOWN PAYMENT = $17,000

Part 3 of the APOD is where we place the rents. Currently the rents are $650 and $575. The front unit is at market and the back unit is a little low, but we will analyze the property using the current rents of $1225.

COMMENTS/FOOTNOTES

$650
575
1225

In Part 4, we work on the income. Our Potential Rental Income would be 12 X $1225 = $14,700. To determine a vacancy rate, we would have to do some research. This area is easy to rent. Also the tenant in the back unit has lived there 15 years. I decided to allow 3% which comes out to 22 days per year. $14,700 X .03 = $441. Our Effective Rental Income is the Gross minus the vacancy,

$14,700 - $441 = **$14,259**

Since there is no Other Income, our Gross Operating Income is the same, $14,259.

1	POTENTIAL RENTAL INCOME		14,700
2	Less: Vacancy & Cr. Losses	(3 % of $)	441
3	EFFECTIVE RENTAL INCOME		14,259
4	Plus: Other Income		-
5	GROSS OPERATING INCOME		14,259

Part 5 of the APOD is where we itemize our Operating expenses. As I have told you, some of these are easy to accurately determine and others take some research.

To determine the taxes, we take the Tax Bill Detail and we look for two things:

1. The Total Rate for the property which is at the bottom of the detail, 1.130738%
2. The sum of the items that are charged as a fixed amount. $149.68 + 370.98 + 20.20 + 2.00 + 7.10 + 372.67 = $922.63.

We then multiply the sales price times the Total Rate as a decimal and add the fixed rate items:

85,000 X .0130738 = $1111.27 + 922.63 = **$2033.90**.

This will give you the new taxes on the property based on a reassessed value of $85,000.

Tax Bill Detail

Fund No	Taxing Agency	Rate	Amoun
00280	GEN LOCAL GOVT	1.000000	580.35
60229	KCWA ZN 7 DEBT	0.031450	18.25
60239	KCWA ZN 17 DEBT	0.009357	5.42
60241	KCWA ZN 19 DEBT	0.014494	8.41
70800	STANDARD BOND 06A	0.020623	11.96
71041	KHS REFUNDING 96A	0.017224	9.99
71042	KERN HIGH 1990E	0.003019	1.75
71043	KERN HIGH 2004A	0.007247	4.20
71044	KERN HIGH 2004B	0.010398	6.03
71045	KERN HIGH 2004C	0.006809	3.95
76962	KCCD SRID 2002A	0.003095	1.79
76963	KCCD SRID 02A RFD	0.005730	3.32
76964	KCCD SRID 2002B	0.001292	0.74
24150	*KCSWMP LAND USE		149.6
40280	NORSD - SEWER		370.9
40830	*C.S.A. 60		20.2
42317	KMVCD VECTOR ASMT		2.0
78038	KCCD ASSMT DIST		7.1
24152	***CENTRAL REFUSE**		372.6
	Total	1.130738%	1,578.79

You will notice the last item on the Tax Bill Detail is 24152, CENTRAL REFUSE, $372.67. This means that the trash fee is paid as part of the tax bill and not separately.

The insurance is a quote, the water is a fixed monthly amount obtained from the water company. The maintenance is the hardest to come up with and would take the most research. In this case, I allowed $1100 for each unit. Reserves are for large item replacements like roofs, heaters, and coolers. Our total operating expense is $6588.

	OPERATING EXPENSES:				
6	Real Estate Taxes			2034	
7	Personal Property Taxes			—	
8	Property Insurance			861	
9	Off Site Management			—	
10	Payroll · Onsite Personnel			—	
11	Expenses / Benefits			—	
12	Taxes / Worker's Compensation			—	
13	Repairs and Maintenance	157.		2205	
	Utilities:				
14	WATER	49		588	
15	TRASH IN TAXES				
16					
17					
18	Accounting and Legal			100	
19	Real Estate Leasing Commissions			—	
20	Advertising / Licenses / Permits			100	
21	Supplies			100	
22	Miscellaneous RESERVES			600	
	Contract Services:				
23	YARD CARE	TENANTS			
24					
25					
26					
27					
28					
29	TOTAL OPERATING EXPENSES				6588

We are now down to the last section of the APOD, #6, we have our gross operating income $14,259, and our Total Operating Expenses, $6588. The difference between these two numbers will give us a very important number, our **Net Operating Income** (the net income if we owned the property free and clear.)

$14,259 – $6,588 = $7671 (NET OPERATING INCOME)

Next, we know the total amount of our mortgage payments (Annual Debt Service) for the year, $5158 and we subtract this from our Net Operating Income to get our Cash Flow Before Taxes.

$7,671 - $5,158 = $2,513 (CASH FLOW BEFORE TAXES)

29	TOTAL OPERATING EXPENSES			6588
30	**NET OPERATING INCOME**			7671
31	Less: Annual Debt Service			5158
32	**CASH FLOW BEFORE TAXES**			2513

Well, all this work was to allow us to determine some important numbers. First is the **CAP RATE.** I hope you will remember why this number is so important. This is our **Bill** number. This is the rate of return if we owned the property free and clear. Our CAP RATE is determined by dividing the Net Operating Income by the Sales Price.

$7671 ÷ $85,000 = .0902   The Cap Rate is 9.02%

Now do you remember what we compare the Cap Rate to? It is the interest rate on the loan, which in this case is 6.5%. The difference, 9.02 – 6.5 = +2.52, means we have a positive Art and Bill Model. (Remember, we have no idea if this is a good deal until we compare it to other properties.)

I want to calculate a few more numbers for you. First is Gross Rent Multiplier which is Sales Price divided by Potential Rental Income.

$85,000 ÷ $14,700 = 5.78

Remember, the lower the Gross Rent Multiplier the better.

Next, I want to calculate the Cash-on-Cash Return which is the Cash Flow Before Taxes divided by the down payment.

$2,513 ÷ $17,000 = 14.78%

Lastly, I want to calculate the total yield on the investment without appreciation. This is equal to the yield from cash flow, debt reduction, and tax benefits.

First we know the cash flow is **$2513**.

Next to find the debt reduction, you would have to find how much principle is paid in the first year of the loan. There are a few different ways to do this; the easiest is with a financial calculator. I will do it and it comes out to be **$760**.

Lastly we will find the tax benefits. First we need to look at the top of the APOD and see what percentage of the value of the property is improvements. We can see our number is 78%. Next we multiply the sales price times the improvement percentage to get the value of the improvements.

$85,000 X .78 = $66,300

Next we divide value of the improvements by the depreciable life of the improvements, 27 ½ years.

$66,300 ÷ 27.5 = $2411

This means that each year, we can show a loss of $2411 on the Schedule E of our tax return for this property.

To find the total tax consequences we need to add the cash flow and debt reduction together and then subtract the tax loss.

$2513 + $760 = $3273.

$3273 – $2411 = +$862.

If the difference of these two numbers is positive, it means that we do not have enough depreciation to make our post tax cash flow a negative number. Therefore we are going to have to pay some money towards income taxes. (Of course if you set up an office in your home, you would have additional write offs.)

Next we multiple this number times the tax bracket the buyer falls in. I usually use 39% (.39) unless told differently.

+$862 X .39 = $336

We would have to pay $336 to the IRS out of our cash flow.

Our net gain would be CASH FLOW + DEBT REDUCTION ± TAX BENEFITS = TOTAL GAIN

$2513 + 760 – 336 = $2837

The TOTAL GAIN ÷ DOWN PAYMENT would give us our **YIELD** on the property without appreciation.

$2837 ÷ 17,000 = 16.69%

Just for any speculators that are reading this book, if the property appreciates 3% for the year, we would get $85,000 X .03 = $2550.

$2513 + 760 – 336 + 2550 = $5387

$5387 ÷ 17,000 = 31.69%

Now, once we have completed an APOD on the property, it is relatively easy to change some of the variables and determine a yield based on a different offer. If we keep the Gross Operating Income and Operating Expenses the same, the Net Operating Income will also be the same. If we change the down payment, or the terms of the loan, only a few numbers change.

Example: With 15% down and an interest rate of 6%, our Loan Amount becomes $72,250, the down payment is reduced to $12,750, our Annual Debt Service becomes $5918, and our Cash Flow beforeTaxes decreases to $1753.

Changing the down payment or terms of the financing does not change our CAP RATE. It is still 9.02%. Because we reduced our interest rate .5%, the difference between our CAP RATE and interest rate is now 3.02, larger than before. Our Cash-on-Cash becomes $1753 ÷ $12,750 = 13.75%.

Our yield becomes:

Cash flow + Debt Reduction ± Tax Benefits ÷ Down payment

$1753 + 887 – 89 = $2551 ÷ 12750 = 20.01%

REDUCING THE AMOUNT OF THE DOWN PAYMENT INCREASES OUR YIELD.

DOWNPAYMENT	CAP RATE	GROSS RENT MULTIPLIER	CASH-ON-CASH	YIELD
20% DOWN	9.02	5.78	14.78	16.69%
15% DOWN	9.02	5.78	13.75	20.01%

Here is the total APOD for El Tejon.

Annual Property Operating Data

Name ______
Location 212 ELTEJON
Type of Property TWO HOUSES ON 1 LOT
Size of Property 1764 ☒ Sq.Ft. ☐ Units

Purpose:
☐ Owner's Statement ☐ Broker's Forecast
☐ Existing Financing ☐ Potential Financing
☐ Seller's Position ☒ Buyer's Position

Date ______
Price $ 85,000
Existing Loan ______
Equity ______

Assessed / Appraised Values		
Land	$ 12,612	22 %
Improvement	$ 45,418	78 %
Personal Property	$	%
Total	$	100 %

Adjusted Basis as of ______ $ ______

		Balance	Payment	#Pmts/Yr.	Interest	Term
Existing	1st	$				
	2nd	$				
	3rd	$				
Potential:	1st	$ 68,000	429.81	12	6.5	360
	2nd	$				

DOWN PAYMENT = $17,000

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME				14,700	$650
2	Less: Vacancy & Cr. Losses (3 % of $)				441	575
3	EFFECTIVE RENTAL INCOME				14,259	1225
4	Plus: Other Income				–	
5	GROSS OPERATING INCOME				14,259	
	OPERATING EXPENSES:					
6	Real Estate Taxes			2034		
7	Personal Property Taxes			–		
8	Property Insurance			861		
9	Off Site Management			–		
10	Payroll - Onsite Personnel			–		
11	Expenses / Benefits			–		
12	Taxes / Worker's Compensation					
13	Repairs and Maintenance	157		2205		
	Utilities:					
14	WATER	49		588		
15	TRASH IN TAXES					
16						
17						
18	Accounting and Legal			100		
19	Real Estate Leasing Commissions			–		
20	Advertising / Licenses / Permits			100		
21	Supplies			100		
22	Miscellaneous RESERVES			600		
23	Contract Services: YARD CARE	TENANTS				
24						
25						
26						
27						
28						
29	TOTAL OPERATING EXPENSES				6588	
30	**NET OPERATING INCOME**				7671	
31	Less: Annual Debt Service				5158	
32	**CASH FLOW BEFORE TAXES**				2513	

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The statements and figures herein while not guaranteed are secured from sources we believe authoritative

Prepared by ______

CASE STUDY – 4208 PARKWOOD COURT – FOURPLEX – SALES PRICE $172,900

This was a bank owned property that came on the market on 6/29/2010. It was on the market for 31 days before an offer was accepted.

Before we get started on analyzing this property, another piece of information your real estateagent should be able to obtain for you is a history of the times the property was on the market duringthe last several years. This can be obtained from the MLS. (Multiple Listing Service)

This property was built in 1977. I could not find the original sales price at that time. I do have the history since 1992.

Sold	**11/11/92**	**$232,000**
Expired	8/14/97	$198,700
Expired	7/1/98	$179,950
Expired	1/8/99	$172,950
Sold	**11/11/99**	**$165,000**
Sold	**1/10/03**	**$226,500**
Expired	5/9/08	$550,000
Sold	**10/13/10**	**$172,900 as a bank owned property**

I mentioned to you that real estate does not always appreciate. Also, we discussed buy low, sell high. An identical property across the street, 4209 Parkwood sold on 10/13/05 for **$564,000**. The owner of 4208 didn't time the market, and got greedy in 2008 when he probably could have still made a big profit.

The first thing we need to do is get a copy of the tax bill or a property profile. I have a copy of the tax bill and under property characteristics I could see that the property was built in 1977 and has 4205 sq. ft. According to the listing, one unit has 3 bedrooms 2 baths and the other units are 2 bedrooms and 1 bath. Each unit has a 2-car garage.

Property Characteristics	
Unit 1	
Year Built	1977
Sq. Ft.	4205
Bed / Bath	2/1

Under Assessment Information you can see that the Land Value is 72,000, Improvement Value is 214,000 and Total is 286,000.

Assessment Information for Tax Year	2010-2011
Prop 8 Values	Assessed Values
Land Value:	72,000
Mineral Value:	0
Improvement Value:	214,000
Other Improvement:	0
Personal Property Value:	0
Total:	286,000

On the APOD, in Section 1 we would place these numbers and then to determine the percentages, we would divide the Land Value by the Total Value and the Improvement Value by the Total Value.

72,000 ÷ 286,000 = .2517 = **25%**

214,000 ÷ 286,000 = .7483 = **75%**

Part 1 of our APOD would look like this:

Name ____________________

Location 4208 PARKWOOD

Type of Property 4-PLEX

Size of Property 4205 ☒ Sq.Ft. ☐ Units

Purpose:

☐ Owner's Statement ☐ Broker's Forecast

☐ Existing Financing ☐ Potential Financing

☐ Seller's Position ☒ Buyer's Position

Assessed / Appraised Values

Land	$ 72,000	25 %
Improvement	$ 214,000	75 %
Personal Property	$ ______	______ %
Total	$ ______	100 %

Adjusted Basis as of ____________ $ ____________

Moving to Part 2 of the APOD, the main information we will need is the terms for a new loan. In this case, we are told that we can get an 80% loan-to-value at 6% fixed for 30 years. Based on a sales

price of $172,900 we can get a loan for $138,300 which gives us a payment of $829.18. Our down payment will be $34,600.

Annual Property Operating Data

Date

Price $ 172,900

Existing Loan

Equity 172,900

Existing		Balance	Payment	#Pmts/Yr.	Interest	Term
1st	$					
2nd	$					
3rd	$					
Potential:						
1st	$	138,300	829.18	12	6	360
2nd	$					

DOWN PAYMENT = $34,600

Part 3 of the APOD is where we place the rents. Currently the rents are $950 and 3@$695 for a total of $3035 which is market rent.

1@ 950
3@ 695
$ 3035

In Part 4, we work on the income. Our Potential Rental Income would be 12 X $3035 = $36,420. To determine a vacancy rate, we would have to do some research. I decided to allow 7% which comes out to 102 days for the property for the year. Our Effective Rental Income is the Potential Rental Income minus the Vacancy and Credit Losses.

$36,420 - $2549 = $33,871

Since there is no Other Income, our Gross Operating Income is the same, $33,871.

1	POTENTIAL RENTAL INCOME		36,420
2	Less: Vacancy & Cr. Losses	(7 % of $)	2549
3	EFFECTIVE RENTAL INCOME		33,871
4	Plus: Other Income		–
5	GROSS OPERATING INCOME		33,871

Part 5 of the APOD is where we itemize our Operating expenses. To determine the taxes, we take the Tax Bill Detail and we again look for two things:

1. The Total Rate for the property which is at the bottom of the detail, 1.176436%
2. The sum of the items that are charged as a fixed amount is $1571.64

Next we multiply the sales price times the Total Rate as a decimal and add the fixed rate items: $172,900 X .0176436 = $3050.58 + $1571.64 = $4622.22

This will give you the new taxes on the property based on a reassessed value of $172,900.

Tax Bill Detail

Fund No	Taxing Agency	Rate	Amoun
00280	GEN LOCAL GOVT	1.000000%	2860.06
60229	KCWA ZN 7 DEBT	0.031450%	89.94
60239	KCWA ZN 17 DEBT	0.009357%	26.76
60241	KCWA ZN 19 DEBT	0.014494%	41.45
70066	BKFLD REFND 89C&D	0.021998%	62.91
70067	BKFLD SCH 93 RFD	0.021957%	62.79
70068	BKFLD SCH 2006-A	0.022366%	63.96
71041	KHS REFUNDING 96A	0.017224%	49.26
71042	KERN HIGH 1990E	0.003019%	8.63
71043	KERN HIGH 2004A	0.007247%	20.72
71044	KERN HIGH 2004B	0.010398%	29.73
71045	KERN HIGH 2004C	0.006809%	19.47
76962	KCCD SRID 2002A	0.003095%	8.85
76963	KCCD SRID 02A RFD	0.005730%	16.38
76964	KCCD SRID 2002B	0.001292%	3.69
20110	**BKFLD-GARBAGE CHG**		6 5.8
20116	BKFLD SEWER PLT 3		6 0.2
24150	*KCSWMP LAND USE		2 9.3
42317	KMVCD VECTOR ASMT		2.0
78038	KCCD ASSMT DIST		14.2
	Total	1.176436%	4,936.24

You will notice the last item on the Tax Bill Detail is 20110, BKFLD-GARBAFE CHG, $655.88. This means that the trash fee is paid as part of the tax bill and not separately.

The insurance is a quote, the water is a metered and the amount was obtained from the water company. The maintenance is the hardest to come up with and would take the most research. In this Case I allowed $1524 maintenance for each unit. Our total expenses were $16,402.

	OPERATING EXPENSES:				
6	Real Estate Taxes			4622	
7	Personal Property Taxes				
8	Property Insurance			1600	
9	Off Site Management				
10	Payroll - Onsite Personnel				
11	Expenses / Benefits				
12	Taxes / Worker's Compensation				
13	Repairs and Maintenance			6098	
	Utilities:				
14	WATER			900	
15	TRASH IN TAXES			–	
16					
17					
18	Accounting and Legal			300	
19	Real Estate Leasing Commissions			–	
20	Advertising / Licenses / Permits			250	
21	Supplies				
22	Miscellaneous RESERVES			1000	
	Contract Services:				
23	YARD CARE			1200	
24	PEST CONTROL			432	
25					
26					
27					
28					
29	TOTAL OPERATING EXPENSES				16,402

We are now down to the last section of the APOD, #6, we have our gross operating income $33,871, and our Total Operating Expenses, $16,402. The difference between these two numbers gives us our Net Operating Income (the net income if we owned the property free and clear.)

$33,871 – $16,402 = $17,746 (NET OPERATING INCOME)

29	TOTAL OPERATING EXPENSES	16,402
30	**NET OPERATING INCOME**	17,469
31	Less: Annual Debt Service	9'950
32	**CASH FLOW BEFORE TAXES**	7519

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Next, we know the total amount of our mortgage payments (Annual Debt Service) for the year, $9950 and we subtract this from our Net Operating Income to get our Cash Flow Before Taxes.

$17,746 - $9950 = $7519 (CASH FLOW BEFORE TAXES)

Our CAP RATE would be:

$17,746 ÷ $172,900 = .1026 The Cap Rate is 10.26%

The difference between the CAP RATE and the INTERESR RATE gives us the ART/BILL Number, 10.26 – 6.00 = +4.26. We have a positive Art and Bill.

The Gross Rent Multiplier is Sales Price divided by Potential Rental Income.

$172,900 ÷ $36,420 = 4.74

The Cash-on-Cash Return is the Cash Flow Before Taxes divided by the down payment.

$7519 ÷ $34,600 = 21.73%

To determine the total yield on the investment without appreciation, we must find the cash flow, debt reduction, and tax benefits.

First we know the cash flow is **$7519**.

The debt reduction is **$1698**.

Next are the tax benefits. We look at the APOD we see the percentage of the value of the property for improvements 75%. We multiply the sales price times the improvement percentage to get the value of the improvements.

$172,900 X .75 = $129,675

Next we divide that number by the depreciable life of the improvements, 27 ½ years.

$129,675 ÷ 27.5 = $4715

We can show a loss of $4715 on the Schedule E of our tax return for this property.

To find the total tax consequences we need to add the cash flow and debt reduction together and then subtract the tax loss.

$7519 + 1698 = $9217

$9217 – 4715 = +$4502.

The difference of these two numbers is positive,

Next we multiple this number times the tax bracket the buyer falls in. Again, I will use 39% (.39).

+$4502 X .39 = $1766

We would have to pay $1766 to the IRS out of our cash flow.

Our net gain would be CASH FLOW + DEBT REDUCTION ± TAX BENEFITS = TOTAL GAIN

$7519 + 1698 – 1666 = $7551

The TOTAL GAIN ÷ DOWN PAYMENT would give us our YIELD on the property without appreciation.

$7551 ÷ 34,600 = 21.82%

If we allowed for 3% appreciation, $5187, our yield would be

$7519 + 1698 – 1666 +5187 = $12,738

$12,738 ÷ 34,600 = 36.82%

Now at first glance it looks like Parkwood is a better deal than the El Tejon property. And my answer is "IT DEPENDS!" Remember, Parkwood is bank owned. It would depend if the units are rented up or vacant. It would depend on how much deferred maintenance exists. The El Tejon property is individually owned and the owner might consider carrying some paper which might reduce the down payment. You as a potential buyer may not have enough cash to purchase Parkwood. There are a lot of things to take into consideration in looking at different properties.

Here is the total APOD for Parkwood.

Annual Property Operating Data

Name ______

Location 4208 PARKWOOD

Type of Property 4-PLEX

Size of Property 4205 ☒ Sq.Ft. ☐ Units

Purpose:
- ☐ Owner's Statement
- ☐ Broker's Forecast
- ☐ Existing Financing
- ☐ Potential Financing
- ☐ Seller's Position
- ☒ Buyer's Position

Date ______

Price $ 172,900

Existing Loan —

Equity 172,900

Assessed / Appraised Values

	$	%
Land	72,000	25
Improvement	214,000	75
Personal Property		
Total	286,000	100 %

Adjusted Basis as of ______ $ ______

	Balance	Payment	#Pmts/Yr.	Interest	Term
Existing 1st					
2nd					
3rd					
Potential: 1st	138,300	829.18	12	6	360
2nd					

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME				36,420	1 @ 950
2	Less: Vacancy & Cr. Losses (7 % of $)				2549	3 @ 695
3	EFFECTIVE RENTAL INCOME				33,871	3035
4	Plus: Other Income				–	
5	GROSS OPERATING INCOME				33,871	
	OPERATING EXPENSES:					
6	Real Estate Taxes			4622		
7	Personal Property Taxes					
8	Property Insurance			1600		
9	Off Site Management					
10	Payroll - Onsite Personnel					
11	Expenses / Benefits					
12	Taxes / Worker's Compensation					
13	Repairs and Maintenance			6098		
14	Utilities: WATER			900		
15	TRASH IN TAXES			–		
16						
17						
18	Accounting and Legal			300		
19	Real Estate Leasing Commissions			–		
20	Advertising / Licenses / Permits			250		
21	Supplies					
22	Miscellaneous RESERVES			1000		
23	Contract Services: YARD CARE			1200		
24	PEST CONTROL			432		
25						
26						
27						
28						
29	TOTAL OPERATING EXPENSES				16,402	
30	NET OPERATING INCOME				17,469	
31	Less: Annual Debt Service				9,950	
32	CASH FLOW BEFORE TAXES				7,519	

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FORM APO-11

CASE STUDY – 520 BEARDSLEY – 20 UNITS – SALES PRICE $675,000

This is a 20-unit complex located on a very large lot. The property is made up of 10 duplexes. Four of the duplexes, 8 units, have 2 bedrooms and 1 bathroom and six of the duplexes, 12 units, have 1 bedroom and 1 bathroom. There is a laundry room that creates some extra income.

Under Assessment Information you can see that the Land Value is 85.012, Improvement Value is 330,223, and Total is 415,235.

Assessment Information for Tax Year	2010-2011
	Assessed Values
Land Value:	85,012
Mineral Value:	0
Improvement Value:	330,223
Other Improvement:	0
Personal Property Value:	0
Total:	415,235
Less Exemption Value:	0
Net Total Taxable Value:	415,235
Tax Rate Area:	057-005 BEARDSLEY

On the APOD, in Section 1 we would place these numbers and then to determine the percentages, we would divide the Land Value by the Total Value and the Improvement Value by the Total Value.

Land Value **85,012 ÷ 415,235 = .2047 = 20%**

Improvement Value **330,223 ÷ 415,235 = .7953 = 80%**

Part 1 of our APOD would look like this:

Name ____________

Location BEARDSLEY AVE

Type of Property ____________

Size of Property 20 ☐ Sq.Ft. ☒ Units

Purpose:

☐ Owner's Statement ☐ Broker's Forecast

☐ Existing Financing ☐ Potential Financing

☐ Seller's Position ☒ Buyer's Position

Assessed / Appraised Values

Land	$ 85,012	20 %
Improvement	$ 330,223	80 %
Personal Property	$	%
Total	$	100 %

Adjusted Basis as of ____________ $ ____________

Moving to Part 2 of the APOD, the main information we will need is the terms for a new loan. In this case, we are told that we can get a 75% loan-to-value at 6.5% fixed for 30 years. Based on a sales price of $675,000 we can get a loan for $506,250 which gives us a monthly payment of $3199.84. Our down payment will be $168,750.

Annual Property Operating Data

Date ______

Price $ 675,000

Existing Loan ______

Equity ______

Existing		Balance	Payment	#Pmts/Yr	Interest	Term
1st	$					
2nd	$					
3rd	$					
Potential:						
1st	$	506,250	3199.84	12	6.5	30
2nd	$					

DOWN PAYMENT $168,750

COMMENTS/FOOTNOTES

Part 3 of the APOD is where we place the rents. Currently the rents are 12@$500 and 8@$565 for a total of **$10,520** which is market rent.

12@ 500
8 @ 565
$10,520

In Part 4, we work on the income. Our Potential Rental Income would be 12 X $10,520 = $126,240. Vacancy is 10% which comes out to be 730 days for the property for the year. Our Effective Rental Income is the Gross Income minus the Vacancy,

$126,240 - $12,264 = $113,616

The laundry room produces about $120 per month in income which is $1440 for the year. The Gross Operating income is **$115,056**

1	POTENTIAL RENTAL INCOME		126,240
2	Less: Vacancy & Cr. Losses	(10 % of $)	12,624
3	EFFECTIVE RENTAL INCOME		113,616
4	Plus: Other Income	LAUNDRY 120	1440
5	GROSS OPERATING INCOME		115,056

Part 5 of the APOD is where we itemize our Operating expenses. To determine the new property taxes, we take the Tax Bill Detail and we get two numbers:

1. The Total Rate for the property which is at the bottom of the detail, 1.167509%
2. The sum of the items that are charged as a fixed amount which is $4404.20

Next we multiply the sales price times the Total Rate as a decimal and add the fixed rate items:

$675,000 X .01167509 = $7880.68 + $4404.20 = **$12,284.89**

This will give you the new taxes on the property based on a reassessed value of $850,000.

Fund No	Taxing Agency	Rate	Amoun
00280	GEN LOCAL GOVT	1.000000	4152.41
60229	KCWA ZN 7 DEBT	0.031450	130.59
60239	KCWA ZN 17 DEBT	0.009357	38.85
60241	KCWA ZN 19 DEBT	0.014494	60.18
70080	BEARDSLEY 2000A	0.007942	32.97
70081	BEARDSLEY 2000B	0.006897	28.63
70082	BEARDSLEY 2006A	0.020855	86.59
70083	BEARDSLEY RF 2007	0.015801	65.61
70084	BEARDSLEY 2006B	0.005899	24.49
71041	KHS REFUNDING 96A	0.017224	71.52
71042	KERN HIGH 1990E	0.003019	12.53
71043	KERN HIGH 2004A	0.007247	30.09
71044	KERN HIGH 2004B	0.010398	43.17
71045	KERN HIGH 2004C	0.006809	28.27
76962	KCCD SRID 2002A	0.003095	12.85
76963	KCCD SRID 02A RFD	0.005730	23.79
76964	KCCD SRID 2002B	0.001292	5.36
24150	*KCSWMP LAND USE		1197.2
40280	NORSD - SEWER		3163.5
40830	*C.S.A. 60		20.2
42317	KMVCD VECTOR ASMT		2.0
78038	KCCD ASSMT DIST		21.3
	Total	1.167509%	9,252.10

You can notice that there is no item for garbage collection on the bill so trash is billed as a separate expense.

The insurance is a quote, the water is a metered and the amount was obtained from the water company. The maintenance is the hardest to come up with and would take the most research. In this case, I allowed $18,936.

By California law, any complex of 16 units or more needs a resident manager. We have a tenant who oversees the property and is allowed a $400 per month reduction on her rent.

Our total expenses were $57,937.

	OPERATING EXPENSES:			
6	Real Estate Taxes		12,285	
7	Personal Property Taxes		—	
8	Property Insurance		5441	
9	Off Site Management	400	4800	
10	Payroll - Onsite Personnel		—	
11	Expenses / Benefits		—	
12	Taxes / Worker's Compensation		—	
13	Repairs and Maintenance	15%	18,936	
	Utilities:			
14	WATER	275	3300	
15	PGE	25	300	
16				
17				
18	Accounting and Legal		1000	
19	Real Estate Leasing Commissions		—	
20	Advertising / Licenses / Permits		800	
21	Supplies		300	
22	Miscellaneous RESERVES		2000	
	Contract Services:			
23	YARD CARE		3000	
24	PEST CONTROL		660	
25	TRASH		5115	
26				
27				
28				
29	TOTAL OPERATING EXPENSES			57,937

We are now down to the last section of the APOD, #6, we have our gross operating income $115,056, and our Total Operating Expenses, $57,937. The difference between these two numbers gives us our Net Operating Income (the net income if we owned the property free and clear.)

$115,056 – $57,937 = $57,119 (NET OPERATING INCOME)

29	TOTAL OPERATING EXPENSES	57,937	
30	**NET OPERATING INCOME**	57,119	
31	Less: Annual Debt Service	38,398	
32	**CASH FLOW BEFORE TAXES**	18,721	

Next, we know the total amount of our mortgage payments (Annual Debt Service) for the year, $38,398 and we subtract this from our Net Operating Income to get our Cash Flow Before Taxes.

$57,119 - $38,398 = $18,721 (CASH FLOW BEFORE TAXES)

Our CAP RATE would be:

$57,119 ÷ $675,000 = .0846 The Cap Rate is 8.46%

The difference between the CAP RATE and the INTERESR RATE gives us the ART/BILL Number, 8.46 – 6.50 = +1.96. We have a positive Art and Bill.

The Gross Rent Multiplier is Sales Price divided by Potential Rental Income.

$675,000 ÷ $126,240 = 5.35

The Cash-on-Cash Return is the Cash Flow Before Taxes divided by the down payment.

$18,721 ÷ $168,750 = 11.09%

To determine the total yield on the investment without appreciation, we must find the cash flow, debt reduction, and tax benefits.

First we know the cash flow is **$7,519**.

The debt reduction is **$5658.**

Next are the tax benefits. We look at the APOD we see the percentage of the value of the property for improvements 80%. We multiply the sales price times the improvement percentage to get the value of the improvements.

$675,000 X .80 = $540,000

Next we divide that number by the depreciable life of the improvements, 27 ½ years.

$540,000 ÷ 27.5 = $19,636

We can show a loss of $19,636 on the Schedule E of our tax return for this property.

To find the total tax consequences we need to add the cash flow and debt reduction together and then subtract the tax loss.

$18,721 + 5658 = $24,379

$24,379 – 19,636 = +$4743.

The difference of these two numbers is positive,

Next we multiple this number times the tax bracket the buyer falls in. Using 39% (.39) we get:

+$4743 X .39 = $1850

We would have to pay $1850 to the IRS out of our cash flow.

Our net gain would be CASH FLOW + DEBT REDUCTION ± TAX BENEFITS = TOTAL GAIN

$18721 + 5658 – 1850 = $22,529

The TOTAL GAIN ÷ DOWN PAYMENT would give us our **YIELD** on the property without appreciation.

$22,529 ÷ 168,750 = 13.35%

If we allowed for 3% appreciation our yield would be

$18721 + 5658 – 1850 + 20250 = $42,779

$42,779 ÷ 168750 = 25.35%

In just looking at the numbers on Beardsley, you might think they look OK. You must compare them with other properties on the market, and you must decide it this is an acceptable yield for you totake the risk.

*** Please note that I did these calculations for the properties without taking into consideration the cost of professional property management. Of course this cost would reduce our numbers. I have seen managers charge a flat fee per unit (ex: $40 per month) and a percentage of the rent collected (ex: 7% or gross income per month). Also, in most cases you may receive additional income from tenants for late charges if they pay past the rental due date.

Here is the total APOD for Beardsley.

Annual Property Operating Data

Name ______
Location BEARDSLEY AVE
Type of Property ______
Size of Property 20 ☐ Sq.Ft. ☒ Units

Purpose:
☐ Owner's Statement ☐ Broker's Forecast
☐ Existing Financing ☐ Potential Financing
☐ Seller's Position ☒ Buyer's Position

Date ______
Price $ 675,000
Existing Loan ______
Equity ______

Existing		Balance	Payment	#Pmts/Yr.	Interest	Term
1st	$					
2nd	$					
3rd	$					
Potential:						
1st	$	506,250	3199.84	12	6.5	30
2nd	$					

DOWN PAYMENT $168,750

Assessed / Appraised Values

Land	$ 85,012	20 %
Improvement	$ 330,223	80 %
Personal Property	$	%
Total	$	100 %

Adjusted Basis as of ______ $ ______

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME				126,240	
2	Less: Vacancy & Cr. Losses	(10 % of $ ______)			12,624	12 @ 500
3	EFFECTIVE RENTAL INCOME				113,616	8 @ 565
4	Plus: Other Income LAUNDRY	120			1440	$10,520
5	GROSS OPERATING INCOME				115,056	
	OPERATING EXPENSES:					
6	Real Estate Taxes			12,285		
7	Personal Property Taxes			—		
8	Property Insurance			5441		
9	Off Site Management	400		4800		
10	Payroll - Onsite Personnel			—		
11	Expenses / Benefits			—		
12	Taxes / Worker's Compensation			—		
13	Repairs and Maintenance	15%		18,936		
	Utilities:					
14	WATER	275		3300		
15	PGE	25		300		
16						
17						
18	Accounting and Legal			1000		
19	Real Estate Leasing Commissions			—		
20	Advertising / Licenses / Permits			800		
21	Supplies			300		
22	Miscellaneous RESERVES			2000		
	Contract Services:					
23	YARD CARE			3000		
24	PEST CONTROL			660		
25	TRASH			5115		
26						
27						
28						
29	TOTAL OPERATING EXPENSES				57,937	
30	NET OPERATING INCOME				57,119	
31	Less: Annual Debt Service				38,398	
32	CASH FLOW BEFORE TAXES				18,721	

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FORM APO-11

CHAPTER 15
PREPARING TO MAKE THE OFFER
AN IMPORTANT RULE I LEARNED EARLY IN MY INVESTING AND SELLING CAREER.

Next, I want to share one of the things that I learned early in my career that can help you in your negotiations. In any transaction there are benefits that are being given and taken. These include the sales price, the amount of down payment, who pays the closing costs, the amount of repairs on the property required by the lender or requested by the buyer, and possible carry back financing by the seller.

Most people think that this involves two parties, the buyer and the seller. In almost all cases this is incorrect. There can be many other parties involved depending on the circumstances at the time. What it really comes down to is motivation. I applied a law during my negotiations, both as a personal buyer or seller, and as an agent.

HE WHO WANTS THE MOST, LOSES.

THE PARTY THAT WANTS THE TRANSACTION TO CLOSE THE MOSTCOULD BE SUBJECT TO BEING TAKEN ADVANTAGE OF.

The seller knows that in order for him to be successful and sell his property he only needs one buyer. Let's say it is a seller's market where there are a lot more motivated buyers than sellers. This was really evident in the early 2000s when a property would be put on the market and there would be several offers within the first few days, some of which were for more than the asking price. NOW, WHO WANTED MOST? Of course it was the buyer. The seller didn't have to give any benefits to get his property sold.

At other times the market will be very slow with few buyers and lots of sellers. In this case a buyer has lots of property choices and should be looking for a great deal. If he writes an offer on a property and the seller counters higher than what the buyer wants to pay, the buyer can just reject the counter offer and tell his agent to go to the next property. Who is going to sell their property in this market? The seller who is motivated the most!

OTHER PARTIES TO THE TRANSACTION MAY ALSO BE MOTIVATED

As I mentioned, there are other parties to the transaction. They may also be motivated.

Example: Let's say that the buyer and the seller are $1000 apart on the price and both are holding firm. The price the seller wants is $100,000 and the buyer only wants to pay $99,000. It looks like the transaction might not be put together. But there are others who would lose out if the offer is not agreed to. Let's assume that the sales commission is 6% that means that each brokerage company would get $3000, usually split between the broker and his agent. It might be that both of the agents are motivated to make the deal work and agree to each reduce their commissions $500 so that the seller will net the proceeds he wants and the buyer will not have to pay an extra $1000. **In this case the agents wanted the transaction to close the most.** I have even seen cases where one agent will not discount his commission and the other agent paid the whole amount. Sometimes agents will pay for repairs when the buyers and seller refuse to pay.

Another case happens when we are in a market like we are today where the property is worth less than the loan amount.

Example: A property is only worth $100,000 today, but there is an $115,000 loan on the property. The seller has no money to add to the transaction and the property loan is in default. It looks like the property will go into foreclosure if something is not done. A buyer makes an offer of $100,000 subject to the bank discounting their loan amount so that the seller can sell without coming out of their pocket. This is called a "short sell" transaction and is very common today. So in this case, the bank is the most motivated because they know if they don't accept the offer and foreclose on the property, it still won't sell for more than the existing value of $100.000 and they will additional costs that will cause them to net even less money. **In this example the bank is the most motivated party in the transaction.**

Example: Sometimes I will list a property that has a conventional first trust deed with a lender and a second trust deed held by a previous owner. Before marketing the property, I will contact the owner of the second trust deed and inform him that the current owner is <u>considering putting the property on the market</u>. I will then ask him if he will consider discounting his 2nd note in order to cash out and increase the chances of a sale. In a lot of cases, the 2nd trust deed holder will agree to discount. If he says "yes," I will draw up an agreement between the owner and 2nd trust deed holder stating the terms of the payoff at an agreed discount amount. If he says, "no," I will then ask if he would be willing to allow his 2nd to be assumed or even if he would subordinate his note to a new 1st trust deed loan. (Allow a new first to be placed on the property in front of his loan.) Sometimes he will agree because he doesn't want to pay takes if he is paid off. In this case, the 2nd trust deed holder may be the most motivated individual in the transaction.

Agents should be thinking about ways to get more benefits for the client they work for.

The moral of the story is to try to be in a position that when you come to the negotiation table, you are <u>not</u> the most motivated individual in any transaction that you are involved in.

BUY LOW – SELL HIGH

One of the first rules that I learned about investing was the rule: Buy Low – Sell High. This rule is very applicable to net worth assets. If you buy gold or some other tangible asset and it appreciates and then you recognize that the trend for your asset is starting down and cause it to lose some its value, you should sell and wait for the trend to turn around again. To me that makes sense.

But over the years, I have heard a new rule, especially applied to the stock market which is called income averaging. This rule states that you keep buying the assets regardless of it is going up or down and regardless if the market is high or low. The supporters of this concept, stock brokers, try to explain that your yield will be higher if you just leave you money in the market and keep adding to your portfolio. Now, I know that no one is smart enough to know exactly when a stock is going up and when it is going down but most experts would have an idea about some kind of trend.

I heard this comparison in the past. Would you play in a poker game if the rules were that you had to bet every hand? I don't think so. Why would an investor sit on the sidelines and watch his portfolio lose a large percentage of value without doing something.

Now my next questions is, how does the Buy Low – Sell High rule apply to investing in real estate?

First of all, a lot of people do apply the Buy Low – Sell High rule with Flippers. They look for depressed, what I call "unloved", properties that they can purchase, make improvements to, and then sell at a profit. I don't consider these people investors. The problem with this process is they don't continue to flip, the income stops. The profit they generate is not passive residual income.

If you remember, our goal is to Win the Game of Money by building a Real Estate Money Machine. We want to produce passive income so that our Wealth Ratio is greater than one. We want to acquire as many cash flow generating properties as we can as fast as we can. We need to know our yield and try to keep it at a high number. I have already discussed ways to re-leverage you portfolio by periodically pulling out equity through refinancing or using a note on one your properties to purchase another property. If you don't particularly like one of your properties, you can exchange your equity from that property into another property using a tax deferred exchange.

We also know that if you just sell a property, you will have to pay capital gains tax on the profit.

So the question is, should you ever just sell your property, pay your taxes, and then wait on the sidelines or invest in another asset class? And the answer is:

It depends!

In 1986, when I owned 100 units that had a negative cash flow, I should have been smart enough to recognize that when Congress passed the Tax Reform Act, my property would lose a large amount of value. If I had taken action immediately, I could have sold all of my properties for a profit and waited on the sidelines for the market to bottom out. Instead, I just sat there and watched as my equity shrank and I kept praying for the market to change. I was like the poker player who has to play every hand. Ignorance was very costly.

So, this was an excellent time to be out of the real estate market.

Fast forward to the early 2000s. I now have 98 units that are providing cash flow, my wealth ratio is well above 1 and I have won the Game of Money. I'm also watching as my properties are appreciating to prices that I can't believe. I had been retired for 2 years but my goal was to move to the mountains and live in my dream house. The question is, should I do anything to take advantage of this market? What do you think? What would you do?

My answer to that question was "YES!"

First I sold one of my rougher properties, a ten-unit on K St for two reasons. First it was the hardest property to manage and 2nd, I would get enough proceeds to pay off my personal residence on Bridlewood Lane in Bakersfield. I discuss more about this later in the book.

Next, I convinced my partners in two properties to sell because I wanted to dissolve the partnership. I was managing 29 units for free and we had different goals. (Review my section on Partnerships for more information)

Lastly, I saw an opportunity to sell some properties and apply my proceeds to purchase my dream home in South Lake Tahoe for cash. I sold four properties and added some additional cash to complete this process.

Address	Type	Date Purch.	Purchase Price	Date Sold	Sale Price	Gross Profit
K Street	10 units	5/99	$142, 716	9/03	$379,950	$237,234
28th St. *	8 units	7/95	$160,000	1/04	$310,000	$75,000
Oleander Ave. **	21 units	7/94	$650,000	12/04	$1,205,000	$138,750
N. Laurelglen	4plex	2/97	$167,500	11/04	$480,000	$312,500
Arrowhead #48	Condo	6/99	$183,000	11/04	$485,000	$302,000
Flower St	6 units	10/01	$96,000	11/04	$257,000	$161,000
Flower St.	2 houses	9/00	$26,828	11/04	$130,000	$103,172
					TOTAL	$1,329,656

* 1/2 ownership

**1/4 ownership

All of the properties mentioned above that I sold in 2003-04 actually increased in value into 2005 and I could have even netted more. But, I was still gun shy from my 1986 calamity and saw an opportunity to really put myself in a great position when I did sell. All these properties headed in a negative direction when the housing crisis hit and are now worth about the same as they were in 2000, before the market started zooming up.

For several years my company sent newsletters every other month to about 4000 residential income property owners in the Bakersfield area. When prices went crazy in 2004-06, I encouraged owners to consider selling their properties and taking their profits. Some people did sell and some exchanged into other properties. But a lot just sat there on the sidelines and watched as their equity came crashing back down.

Of course, I was amazed to watch buyers fighting over purchasing properties that made absolutely no sense if you analyzed them. TGR Realty worked almost exclusively with sellers during this time. We could not advise anyone to purchase property during this crazy seller's market.

REAL ESTATE DOES NOT ALWAYS APPRECIATE

When I first started investing in real estate in 1976, I didn't have a lot of knowledge about the history of real estate prices. I could see that over the last 10 years, property was going up in value and I naively believed that this trend would always occur.

As you know, I learned the hard way. I would like to tell you another story regarding this topic. In 1980 I purchased a 5 plex for $155,000. I placed a new conventional loan on the property with a 30 year amortization but it had a 15 year balloon payment. This was the only property I kept from the 100 that I owned in 1986. In 1995, I knew that the bank wanted to be paid off so I applied for a new loan from a lender. They sent out an appraiser and when he was done, he wrote up a new appraisal on the property for $135,000. I had owned the property for 15 years and it went down $20,000. So much for real estate always going up in value!

Over the years I have sold dozens of properties for less than the price the owner had paid for the property. **DON'T COUNT ON REAL ESTATE GOING UP IN VALUE.**

THE WORST TIME TO INVEST

"The worst time to invest is when the market is good. The best time to get rid of non-performing assets in your portfolio is when the market is good and amateurs are in the market buying. Tales of success bring suckers to the market." – Rich Dad

"Be fearful when others are greedy and be greedy when others are fearful." – Warren Buffett

GREED + STUPIDY = OPPORTUNITY

COULD THIS SAME PHILOSOPHY APPLY TO PERSONAL RESIDENCES?

I have two sister-in-laws that live in Bakersfield. Both owned modest homes in lower income neighborhoods. One sister-in-law had been recently divorced and before the boom her house was worth round $60,000. She called me one day and told me that someone was interested in purchasing her home for $180,000. I told her I thought she should sell, go rent a nice place for a couple of years, and then when the prices came back down, she could buy a lot nicer home with her cash proceeds. She didn't owe much on her home and decided to keep it because it would be free and clear in a short period of time. Her home is now worth around $60,000 again.

My other sister-in-law and her husband did sell their home, but instead of waiting on the sidelines until the prices came down, they went out and bought a more expensive house at the top of the market. A couple of years, later, they got a loan modification but they still owed a lot more than the property was worth. Finally they sold their house to an investor on a "short sale" transaction and ended up renting the house back from the investor.

Both of my relatives missed opportunities to better themselves because of lack of knowledge and making emotional decisions instead of logical decisions.

After I purchased my home in South Lake Tahoe, I kept my home in Bakersfield for 2 years before selling it. As you can see, I made a pretty good profit from less than 7 years of ownership

Address	Type	Date Purch.	Purchase Price	Date Sold	Sale Price	Gross Profit
Bridlewood	Per. Res.	9/00	$185,000	1/07	$375,000	$190,000

If I had stayed in Bakersfield, it would have been smart to sell my home at the top of the market, rent for a couple of years and then reinvest. However, I'm not sure I could have talked my wife and family into the idea and I'm not sure I would have done it even if they agreed. Earlier in my life when I was just starting out, it would have made a lot more sense.

ANOTHER PHILOSPHY ABOUT MAKING OFFERS ON PROPERTIES

The market is constantly changing from a seller's market to a neutral market to a buyer's market, and then back to a neutral market.

When you have a buyer's market, there are more properties for sale than buyers. During this time, you will find very motivated sellers. Let's say you want to buy one property and you find three properties that are very interesting to you. Which seller will give you the best deal? Here is a strategy for you to consider.

Write offers on all three properties at the same time. Price your offers significantly less than what you think the properties are worth. See if you get an acceptance or counter offer from each of your offers. Try to get the sellers down to their bottom line. Do your interior inspection on each property that has accepted your offer. Pick the best property to purchase and tell the other owners of the properties that you are not purchasing that you are withdrawing your offer by disapproving of one of the conditions in your offer. (Such as approval of the interior inspections or approval of rental agreements.)

If you feel that one of the owners is even more motivated, you can counter your price after the inspections.

Now this is more work for your real estate agent, but especially in a slow market, he should be willing to do what it takes.

HOW TO WRITE THE OFFER

(Goal – to apply all the information that you have gathered and determine what benefits youwant to get for you to get the highest yield possible.)

O.K., you've looked at a lot of properties. You have done analysis on those that you are most interested in to determine your potential yield. You have picked a property you feel comfortable about and are willing to write an offer. What happens next?

HOW DO YOU DETERMINE WHAT YOU WILL OFFER FOR THE PROPERTY?

First of all, it is a natural instinct for you as the buyer to have a fear that you might offer more than what the seller will take for his property. I never had a problem shaving the sales price a little to try to get a lower price for the property.

However, you can also have a situation where you offer way less than what the seller will accept and either the seller or the agent gets ticked off because they feel insulted. There have been times when I have had a buyer contact me to make an offer on a property that I felt was completely ridiculous and I refused to work with the buyer.

Let's say that you decide to write an offer on the fourplex located at 987 Center Street. It is listed for $225,000. The property has been on the market for 1 month and there has been one comparable sell in the last 3 months that sold for $220,000 cash to a new loan. You have been prequalified by a lender that will make an 80% loan on a fourplex.

Well, all that information above is very interesting but your offer should be written based on your APOD form and the yield that you are looking for on the investment of your capital. As we have discussed previously, yield is determined by such things as the interest rate of the loan, the income and expenses the property generates, the price you pay for the property, and your down payment. We'll hypothesize that the Center Street property will provide you with the yield that you want with a full price offer and cash to a new loan.

We have already discussed that in order for an offer to be accepted, it must be a win-win for the buyer and seller and the motivation of each party determines what they consider as a win for them.

Most listing agents will do what is called a "Net Sheet" for the seller where the sales price, costs of sale, loan payoff, rent proration, tenant deposit transfer, and any other costs are listed and then all of the expenses are subtracted from the sales price to determine what the net proceeds will be for the seller. The bottom two lines on the Net Sheet is what the seller is looking at to see if he wins. (I have provided an example of a net sheet for the seller on the next page.)

SELLER'S NET SHEET

Seller's Name(s) ____

Property Address ____

	Debit	Credit
Sales Price		
Escrow Fee		
Title Policy		
Tax Proration		
Documentary Transfer Fee		
Notary Fees		
Recording Fees		
NHD Report and Processing		
Commission		
Home Protection Plan		
Tenant Deposits		
Rent Proration		
Payoff 1st Loan		
Interest Owed 1st Loan		
Payoff Statement Fee		
Payoff 2nd Loan		
Interest Owed 2nd Loan		
Termite Clearance		
Roof Certification		
Repairs		
Note to Seller		
Cash to Seller		

Let's say that the seller wants to sell but does not want to "give the property away." Hopefully, you have determined some information about the seller and the property from the research that you have done. Maybe the property is in loan default or the owner is behind on this property taxes. Maybe the listing agent has disclosed that there is a divorce going on or the sellers are moving across country and don't want to have to worry about management. It helps to know this information before you make the offer. Some sellers will play it "cool" even though they are in deep financial distress on the property.

O.K., let's go back to Center Street. We know that if we just make a full price offer, cash to loan, the seller will be happy and you will get your desired yield. But if you are a true investor, you will try to increase your yield. Therefore you're going to ask for a few more benefits on your side of the ledger.

In most transactions, the two main bargaining areas are the sales price and the down payment. Most sellers prefer to cash out but when the market is tough, a lot of times they will consider carrying some paper. (The seller making a loan to the buyer for part of the seller's equity.)

You consider two offers:

Offer A – Sales price to be $217,000 cash to a new 80% loan.

Offer B – Sales price to be $220,000 cash to a new 80% loan. Buyer to give seller a note and 2nd trust deed secured on the Center Street property for $22,000, payments amortized over 30 years at 7% interest, all due in 10 years.

Let's first look at the net proceeds to the seller based on the two offers.

OFFER #A

CASH TO NEW LOAN - $217,000 SALES PRICE

SELLER'S NET SHEET

Seller's Name(s) ______________________________

Property Address: 987 Center Street

	Debit	Credit
Sales Price		217,000
Escrow Fee	433	
Title Policy	802	
Tax Proration	1250	
Documentary Transfer Fee	239	
Notary Fees		
Recording Fees	70	
NHD Report and Processing	60	
Commission	13,020	
Home Protection Plan	-	
Tenant Deposits	2800	
Rent Proration	2600	
Payoff 1st Loan	123,500	
Interest Owed 1st Loan	720	
Payoff Statement Fee	30	
Payoff 2nd Loan		
Interest Owed 2nd Loan		
Over Night Fee	75	
Termite Clearance	600	
Roof Certification	200	
Repairs	1300	
Total Costs of Sale	147,699	
Note to Seller		
Cash to Seller		69,301

OFFER #B

CASH TO NEW LOAN PLUS 2ND NOTE CARRY BACK - $220,000 SALES PRICESELLER'S NET SHEET

Seller's Name(s) ______________________________________

Property Address: 987 Center St.

	Debit	Credit
Sales Price		220,000
Escrow Fee	433	
Title Policy	802	
Tax Proration	1250	
Documentary Transfer Fee	242	
Notary Fees		
Recording Fees	100	
NHD Report and Processing	60	
Commission	13,200	
Home Protection Plan		
Tenant Deposits	2800	
Rent Proration	2600	
Payoff 1st Loan	123,500	
Interest Owed 1st Loan	720	
Payoff Statement Fee	30	
Payoff 2nd Loan	-	
Interest Owed 2nd Loan	-	
Over Night Fee	75	
Termite Clearance	600	
Roof Certification	200	
Repairs	1300	
Total Costs of Sale	147,912	
Cash to Seller		50,080
Note to Seller		22,000
Total Proceeds to Seller		72,080

The note for $22,000 would have payments of $146.37 per month at 7% interest due in 10 years. The benefits to the seller are an additional $2779 in net proceeds and qualification for a partial installment sale, which would save him some taxes.

Which offer would be the best deal for you, or in other words, the highest yield? Once you have your APOD written up, it is easy to compare different down payments and financing to see what happens.

On the next two pages are APODs for Center Street that I have put together.

Suppose I'm your agent and we are discussing the numbers. Are you going to take my word regarding the numbers I am presenting?

The answer is:

"It depends!"

If you have been doing your homework by finding about these numbers yourself on other properties, you will recognize if they make sense or not. If this is all new, you need to take the APODs and start doing your due diligence.

In other words, you should be in a position that you don't have to trust anyone else. I have already given you specific instructions on how and where to find the numbers presented in an APOD.

OFFER A

Annual Property Operating Data

Name ____

Location 987 CENTER ST

Type of Property 4-PLEX

Size of Property 4200 [x] Sq.Ft. [ ] Units

Purpose:

- [ ] Owner's Statement
- [x] Broker's Forecast
- [ ] Existing Financing
- [ ] Potential Financing
- [ ] Seller's Position
- [ ] Buyer's Position

Date ____

Price $ 217,000

Existing Loan 123,500

Equity 93,500

	Balance	Payment	#Pmts/Yr.	Interest	Term
Existing 1st	$ 123,500	978.90	12	7.5	264
2nd	$				
3rd	$				
Potential 1st	$ 173,600	1097.27	12	6.5	360
2nd	$				

DOWN PAYMENT $43,400

Assessed / Appraised Values

		%
Land	$ 33,000	19 %
Improvement	$ 138,600	81 %
Personal Property	$	— %
Total	$ 171,600	100 %

Adjusted Basis as of ____ $ ____

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME				38,400	RENT
2	Less: Vacancy & Cr. Losses (7 % of $)				2688	
3	EFFECTIVE RENTAL INCOME				35,712	1 @ 950
4	Plus: Other Income				—	3 @ 750
5	GROSS OPERATING INCOME				35,712	$3200
	OPERATING EXPENSES:					
6	Real Estate Taxes			3540		
7	Personal Property Taxes			—		
8	Property Insurance FARMERS QUOTE			1600		
9	Off Site Management			—		
10	Payroll - Onsite Personnel			—		
11	Expenses / Benefits			—		
12	Taxes / Worker's Compensation			—		
13	Repairs and Maintenance	15%		5760		
	Utilities:					
14	WATER	70		840		
15	GAS / ELECT.	10		120		
16				—		
17				—		
18	Accounting and Legal			100		
19	Real Estate Leasing Commissions			—		
20	Advertising / Licenses / Permits			300		
21	Supplies			100		
22	Miscellaneous RESERVES			1000		
	Contract Services:					
23	YARD CARE			1200		
24	PEST CONTROL			480		
25						
26						
27						
28						
29	TOTAL OPERATING EXPENSES				15,040	
30	**NET OPERATING INCOME**				20,672	
31	Less: Annual Debt Service				13,167	
32	**CASH FLOW BEFORE TAXES**				7505	

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Prepared by ____

FORM APO-11

OFFER B

Annual Property Operating Data

Name ______
Location 987 CENTER ST
Type of Property 4 - PLEX
Size of Property 4200 ☒ Sq.Ft. ☐ Units

Purpose:
☐ Owner's Statement ☒ Broker's Forecast
☐ Existing Financing ☐ Potential Financing
☐ Seller's Position ☐ Buyer's Position

Date ______
Price $ 220,000
Existing Loan 123,500
Equity 96,500

Assessed / Appraised Values

		%
Land	$ 33,000	19 %
Improvement	$ 138,600	81 %
Personal Property	$	%
Total	$ 171,600	100 %

Adjusted Basis as of ______ $ ______

	Balance	Payment	#Pmts/Yr	Interest	Term
Existing					
1st	$ 123,500	978.90	12	7.5	264 mo
2nd	$				
3rd	$				
Potential:					
1st	$ 176,000	1124.44	12	6.5	360
2nd	$ 22,000	146.37	12	7	360/12

*DOWN PAYMENT $22,000

	ALL FIGURES ANNUAL	$/SQ.FT. or $/Unit	%			COMMENTS/FOOTNOTES
1	POTENTIAL RENTAL INCOME				38,400	
2	Less: Vacancy & Cr. Losses (7 % of $ ______)				2688	RENT
3	EFFECTIVE RENTAL INCOME				35,712	1@950
4	Plus: Other Income				-	3@750
5	GROSS OPERATING INCOME				35,712	= 3200
	OPERATING EXPENSES:					
6	Real Estate Taxes			3585		
7	Personal Property Taxes					
8	Property Insurance FARMERS QUOTE			1600		
9	Off Site Management			-		
10	Payroll - Onsite Personnel			-		
11	Expenses / Benefits			-		
12	Taxes / Worker's Compensation			-		
13	Repairs and Maintenance	15%		5760		
	Utilities:					
14	WATER	70		840		
15	GAS/ELECT	10		120		
16						
17						
18	Accounting and Legal			100		
19	Real Estate Leasing Commissions			-		
20	Advertising / Licenses / Permits			300		
21	Supplies			100		
22	Miscellaneous RESERVES			1000		
	Contract Services:					
23	YARD CARE			1200		
24	PEST CONTROL			480		
25						
26						
27						
28						
29	TOTAL OPERATING EXPENSES				15,040	
30	**NET OPERATING INCOME**				20,672	
31	Less: Annual Debt Service				15,250	
32	**CASH FLOW BEFORE TAXES**				5422	

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Prepared by ______

FORM APO-11

So what do we do next? First we look at the Art and Bill model. We need to find the cap rates and compare them to the loan interest rates. Remember, cap rate is the net operating income divided by the sales price.

Offer #A $20672 ÷ $217,000 = 9.53%

Offer #B $20672 ÷ $220,000 = 9.40%

Our interest rate on **Offer #A** was 6.5% and on **Offer B it was 6.5% and 7%.** So we have a nice positive ratio between Art and Bill.

Next, we can take numbers from the APOD and use them to determine our yield on the property. Remember there are 4 ways we make money with residential income property:

1. **Cash flow**
2. **Debt Reduction**
3. **Tax Benefits**
4. **Appreciation**

1) We know our cash flow is item #32 so that is easy to find.

2) Using a financial calculator, we can find the amount of principle paid on each loan for a year.

3) To find the yield from tax benefits of ownership, we use the formula:

Sales price X % of improvements ÷ 27.5 yrs = Depreciable loss each year.

For **Offer #A**, we get: $217,000 X .81 ÷ 27.5 = $6392. If you are in the 39% tax bracket you would combine the cash flow and the debt reduction and then subtract the depreciation which gives us your actual profit or loss, then multiply by 39%.

$7505 + $1940 – $6392 = $3053 X .39 = $1191

Since the total sum is a positive number, we would have to pay to the IRS $1191 for income taxes.

For Offer #B, $220,000 X.81 ÷ 27.5 = $6480

$5422 + $2190 – 6480 = $1132 X .39 = $441 to the IRS.

Next to determine the yield, we will take our total return and divide it by our down payment.

For **Offer #A**, $8254 ÷ $43400 = 19.02%

For **Offer #B**, $7171 ÷ $22,000 = 32.60%

TABLE A

Offers	Cash Flow	Debt Reduct	Tax Benefits	Total Return	Down Payment	Yield
Offer #A	**7505**	**1940**	**(1191)**	**8254**	**43,400**	**19.02%**
Offer #B	**5422**	**2190**	**(441)**	**7171**	**22,000**	**32.6%**

So what can we learn from these two APODs on Center Street. First of all, our cash flow from **Offer #A** is $1294 greater that **Offer #B** ($6717 – 5422). Our debt reduction for Offer #B is higher because we have more financing on the property. We will have to pay a little more income taxes to the IRS on Offer #A because the sum of our cash flow and debt reduction is larger. But why are the yields so much different? The answer is with **Offer #B**, our down payment is significantly less so we are dividing by a lot smaller number.

Let's calculate some other numbers that I think you will find interesting. First is Gross Rent Multiplier. Gross Rent Multiplier is Sales Price divided by Gross Yearly Income.

Offer #A $217,000 ÷ $38,400 = 5.65

Offer #B $220,000 ÷ $38,400 = 5.72

Remember the lower the GRM, the better.

Next, we will calculate the Cash-on-Cash return by taking the net cash flow and dividing by our down payment.

Offer #A $7505 ÷ $43,400 = 17.29%

Offer #B $5422 ÷ $22,000 = 24.65%

After all this work, you can see that we are better off with offer #B yield wise. If we could get the seller to accept Offer #B, would this be a good deal? Are you ready to sign the paper work based on what you see?

But wait, we know there are four ways of making profit in real estate. There are cash flow, debt reduction, tax benefits, and appreciation. Let's analyze our return with a measly 3% appreciation rate. Let's look at our table again.

TABLE B

Offers	Cash Flow	Debt Reduct	Tax Benefits	Appre-ciation	Total Return	Down Payment	Yield
Offer #A	**7505**	**1940**	**(1191)**	**6510**	**14764**	**43,400**	**34.0%**
Offer #B	**5422**	**2190**	**(441)**	**6600**	**13771**	**22,000**	**62.6%**

Now if you are a speculator, you are going to get excited about Table B, but if you are an investor, Table A is what you will make your decision on.

O.K., you have seen a lot of numbers and you are asking yourself "What is going on?" And my answer is, **you are learning how to become an investor**. You are learning what numbers you need and how to use those numbers to project the yield on an investment. You are doing this to reduce your risk and increase your chances of being a successful professional investor. If you don't understand the numbers, go over them a few more times. If they still don't make sense, get a math basics book and study it. Don't be in a position that you are afraid to make a decision because you don't understand the numbers or you make a decision without knowing the numbers. Be smart.

So is 987 Center St. a good deal. I hope you know the answer by now.

IT DEPENDS!

Have you done your homework and compared it to other properties? Will the yield help you reach your goals?

HOW ACCURATE ARE THE NUMBERS IN OUR APOD?

For Offer A you can see that I have projected the **CASH FLOW BEFORE TAXES** to be $7505. Do you think that at the end of the first year, this number will exactly be the bottom line? No one is that good!

There are some numbers that you can determine very accurately. Once you have the loan information, you will know exactly how much your payment will be for the year. Taxes and insurance can be determined with a little effort. Utilities and Contract services are pretty easy to determine. But how about vacancy loss, advertising, repairs and maintenance? How close can anyone really

You can get an idea of averages for these items from management companies, appraisers, other property owners, and knowledgeable real estate agents. There may even be some statistics you can find on the Internet. But those are averages. You can't tell for sure when something major will break such as an air conditioner, heater, or stove. **There is risk involved!**

This risk becomes compounded when you take into account the quality of the management. The numbers presented for Center Street may be a lot lower with excellent management and higher with poor management.

No one can eliminate the risk completely.
You have to decide if the risk is worth the reward.

SHOULD YOU EVER PURCHASE A PROPERTY IN "AS IS" CONDITION?

This was a question that I am asked frequently and the answer is: **"It depends."**

First of all, you should know that it is possible to make a lot of money buying a property "as is" and it is also possible to lose a lot of money buying a property "as is."

Second, buying a property "as is" doesn't mean that the buyer can't have as many inspections as he wants and make the sale subject to the buyer's approval of the inspections. You can also have as your only contingency that the sale is subject to an interior inspection and approval by the buyer and bring in your inspectors with you at the time you do the interior inspection.

Third, sometimes you will not be able to purchase a property "as is" if you are getting a new loan. Most lenders will want some basic inspections and clearances as part of the loan transaction such as a clear termite report and maybe a roof inspection and certification. You will also find that when the appraisal is done, the appraiser looks for any evidence of damage or deferred maintenance and may make "repairs to the property" a contingency for obtaining the loan.

Another important question to ask is "What are my plans for the property after I purchase it?" If you are going to fix the property up, raise the rents, and then sell or exchange the property, then it would be smart to get all the inspections that you need to really determine the condition because a new buyer will probably request a lot of inspections. In most cases, you are going to sell the property "for cash to a new loan" so you can realize all your equity to move on to the next project. You don't want to be surprised if there is a major repair that needs to be made that you weren't aware of.

Sometimes the units may be newer or well-maintained that may cause a buyer to purchase "as is." But in almost all cases, there will be some deferred maintenance that is needed on the property.

A reasonable owner should understand that if a buyer doesn't request that he do any type of repairs to the property as part of the contract, he will probably save some money and that is a benefit to him. There are some cases where repairs may warrant that the tenants vacate the property for a day or two (ex: tenting a unit to kill termites) which may cause the owner to have to pay for a hotel room for the tenant(s).

My experience for the most part was that a buyer can purchase a property for less if he makes an "as is" offer to the seller. Unfortunately, some sellers think that their 40-year old property is in perfect shape and only wants top dollar. There are two ways to handle this situation.

1. Make an offer with as many inspections as you want and request the seller to pay for the repairs. You want to make sure that if you are paying "top" dollar, you are getting the property in "top" condition.
2. If the owner says "no", move on to the next property.

SHOULD I BUY A HOME WARRANTY CONTRACT?

Well, can you guess what my answer to this question is?

IT DEPENDS!

A home warranty is an insurance policy that covers the electrical, plumbing, heating, and cooling systems for a property, usually for the 1st year of ownership. Usually it is extra to cover forced air heating and air conditioning units. Normally it can be renewed each year by the owner. The purchase of a home warranty contract is very common for owner occupied single family homes and is usually paid for by the seller.

The decision you have to make is do you want to pay a premium that will protect you for a year or do you want to keep your premium cost and have it for a reserve to pay for any repairs.

If you have a good home inspection company check the property before you close escrow, you may get their advice about purchasing a policy. I can’t every remember buying a home warranty policy personally or for my clients over the years.

My advice is to get the numbers and then way the advantages and disadvantages.

CHAPTER 16
WRITING THE OFFER
THE GOOD FAITH DEPOSIT

One of the first clauses that you will see on your purchase agreement is the making of a GOOD FAITH DEPOSIT. Offers to purchase real estate are required to have something of value put up as an initial good faith deposit or the offer is not valid. Now this good faith deposit can be $1, a car, emerald stones, or $1,000,000.

The reason for this is to give some protection to the seller should the buyer act in bad faith and try to back out of the transaction after all contingencies have been removed and the escrow is ready to close within the time limit allowed by the offer.

There are no rules about the amount of the deposit, but as both a buyer's and seller's agent, I liked a deposit of at least 1% of the sales amount.

Example: I an offer was made on a property for $100,000, I felt comfortable with a deposit of $1000 unless there were some weird things going on in the market like multiple offers. Then I would probably want a higher deposit.

Normally it is required that the deposit be placed in escrow or the broker's trust fund within 3 business days. However, there can be exceptions. I always write that "the deposit will be placed within 3 business days of buyer's approval of the interior of the units."

Now if everything goes smoothly, the deposit will be applied towards the purchase price. If during the discovery period, either party decides to cancel the escrow for a legitimate reason (per a contingency), the deposit will be returned to the buyer.

Let's suppose we are the seller and we have an accepted offer, escrow is opened, all the contingencies have been removed, and the escrow is in position to close. We get a call from the buyer or buyer's agent stating that the buyer has changed his mind and no longer wants to purchase the property. If the buyer defaults, then one of several things can happen. In the purchase agreement for California is a LIQUIDATED DAMAGES CLAUSE which if initialed by the buyer and seller limits the damages to be paid to the seller to be equal to the good faith deposit. If the clause is not initialed by both parties, the seller will have the right to sue the buyer for up to 3% of the purchase price. In the first case, the buyer would have to sign an amendment to the escrow forfeiting his deposit to the seller.If the buyer will not sign the amendment, the seller can either release the deposit to the buyer or take legal steps to collect the deposit amount. If nothing happens, the deposit stays with the escrow company for a period of time and then it can be given to the state.

It's not quite that easy if the seller decides that he no longer wants to sell the property. The buyer can choose to just walk away or he can seek legal recourse by suing for specific performance. This means that the buyer is demanding that the seller honor the contract and complete the sale. During this time property will be tied up where it cannot be transferred to anyone else by the seller. Next either the seller agrees to sell or it's time to go to court.

Unfortunately, I have been involved in a couple of actions like this and in most cases, the seller will settle with the buyer before the case goes to court.

The California Association of Realtors© "RESIDENTIAL INCOME PROPERTY PURCHASE AGREEMENT AND JOINT ESCROW INSTRUCTIONS" is 10 pages long just by itself. There are additional documents that need to be signed such as an AGENCY DISCLOSURE form.

I recommend you get a blank copy of all the documents that will be involved in a transaction when you first meet with your real estate agent and then go home and review them carefully. Highlight any areas that you have questions on. When you agent writes the offer, he will also go over the different clauses with you before you sign the documents.

PRESENTING THE OFFER

(Goal – to have the offer presented in such a way that will give you the best chance ofacceptance with the benefits you are looking for)

I was the top listing agent of residential income property in my market for many years. One of the major things that amazed me as a listing agent was how most of the agents representing the buyer would have their offer presented to the seller. I have mentioned several times that the standard procedure for buying and selling single family owner-occupied homes is different than non-owner occupied residential income property. Most offers for the owner occupied home are written as cash-to-a-new-loan with standard requests for inspections and clearances.

The deposit receipt for multi-family properties is a couple of pages longer and has some major contingences that make the offer a lot more complicated. These come from such areas as:

- Financing of the property can be a lot more complicated with more chances of formalassumption of the existing loan or the creation of a new second loan including ownercarry back.
- There are in most cases, requests by the buyer for additional information from the seller such as a rent roll, expense statement, copies of rental applications and rental agreements, estoppel certificates, the last two income and expense statements from a management company, or even owner tax returns for the last few years showing the property's income and expenses.
- There are usually more inspections and the possibility or more repairs. These include an interior inspection by the buyer after the offer is accepted by the seller.

As a listing agent, I would want to know some things about the buyer and of course I required a prequalification letter and proof of down payment if there was going to be a new loan. If there was an assumption or an existing loan or the creation of a new loan, especially a carry back by the seller, I required similar documents that a bank would require such as loan application, verification of employment and down payment, and a credit report.

Here are some examples of the methods different agents have presented an offer to me on one of my listing.

- Drop the offer by my office without even calling me.
- Call me to inform me they had an offer and then drop it by the office.
- Fax or email me the offer
- Get me a copy of their offer and then call me to explain it.
- Make an appointment with me at my office and bring the offer to me and see if I had any questions.

As you can see in these examples, the buyer's agent never meets with the seller to present the offer directly to him.

In my opinion, none of these techniques represented a fiduciary duty of utmost care, integrity and honesty in trying to do the best professional job the agent can do for the buyer.

It is important to remember that nobody wins unless an escrow is closed. It is the responsibility of the listing agent and the selling agent to work together to try to put together a win-winsituation for the buyer and the seller. Most agents cooperate within their duty to positively strive to make the offer work. If the buyer or the seller cannot be made happy after negotiations, it means it is time to move on to another property or buyer.

Here is what I did and what I recommend you tell your real estate agent you want done when they present your offer.

As the buyer's agent, I would call the listing agent and have him set up an appointment with the seller, the listing agent and me to meet somewhere (usually the listing agent's office or the seller'shome). If the seller lived out of the area, I would have the listing agent set up a conference

Now, depending on the listing agent I would do the following.

If I had worked with the listing agent before and I knew they were professional, I might meet with them before I presented the offer to explain what the offer was, how we arrived at it, and get a little feedback from the listing agent. If I felt I needed to, I would prepare some comparable sales thatI could show the seller that justified our offer price. I would have the buyer's prequalification letter and proof of down payment and any other information showing that my buyer was strong.

If the listing agent was someone that I knew mostly sold single family homes, was a new agent, or an agent that I could tell was not knowledgeable about marketing multiple family units, I usually would not meet with them before the offer. When we met, I would introduce myself as the owner of a company that specialized in selling residential income property exclusively and hand the seller and agent my card. (I want to establish my knowledge and expertise.) After that, my reason for being there is to professionally represent my buyer. I will go through the offer page by page, discussing the key points of the offer and what benefit the seller will get. I will ask the seller questions and try to get feedback. I will ask the seller if he has any questions as I go through the offer. I will have a comparable sales form and a net sheet.

All this time, I am trying to read the seller to see if I can get a feel about his thoughts on the offer. My offer will have a statement on it that the offer is only good for a few days and then it is void.

One of the interesting questions that will sometimes be asked by the selling agent or the seller to me is, "Will the buyer go higher on his offer." Now, how do you think an agent with integrity would answer this question? My answer is always, "The price that is being offered is the price that the buyer feels is a fair offer. I have no idea whether he will go any higher or not. I think you should seriously consider this offer."

After hearing the offer, the seller has three choices. He can

1. Accept the offer
2. Counter the offer
3. Reject the offer – a good listing agent will work hard to get a counter if the seller is not happy.

Next, one of two things will happen. The listing agent will have me leave the room while the seller's agent discusses the offer with the seller. Sometimes they will have an acceptance or a counter offer at this time for me to take back to the buyer or the listing agent will tell me that they will get back to me later and I will leave and wait for their reply.

Whatever the case, I will contact my buyer immediately and inform them how the offer went.

Let me share another side to this situation when I represented the seller. Let's say the offer is for $175,000, and the seller thinks the offer is fair. The seller asks me if I think we should counter the offer, let's say to $180,000 to see if we can get a little more from the buyer. Now this is a risk because the buyer may reject the counter and move on to another property. I haven't met the buyer yet and cannot judge him. Here is a way that I would sometimes answer the seller's question.

"You have an offer that if you accept and everything goes well will give you a price of $175,000. You will no longer own the property. If you counter the price to $180,000, you are in effect telling the buyer that you want to buy the property back from him at $180,000 and take your chances if he will come back or not. Is it worth it?"

Now in some cases, the buyer may come back at $180,000. In other cases, he will stay firm at $175,000 or counter back at a price in between. And in some cases, he will move on.

These are the risks involved in the negotiations.

If an offer comes in below what the market dictates the value of the property, it will come down to the motivation of the seller.

Hopefully, with some negotiation both parties can be made happy.

THE PHILOSOPHY OF NEGOTIATION

In any transaction, there are benefits available to the parties involved. A seller must have some reason to sell and a buyer some reason to buy. These are many times different when it comes to single family homes compared to residential income property.

Most single family homes really involve one major benefit for each party, the net proceeds to the seller and the sales price to the buyer.

This is not true for residential income property. The seller is still looking for net proceeds but the buyer should be looking to design the transaction so as to increase his potential yield. As we have discussed, leverage is a big determiner of yield: If we are using the Art and Bill model, usually the less cash down payment, initial investment, the higher the yield.

As a buyer or a seller, you want an agent who knows what benefits you want and understands how to negotiate to get those important benefits you are looking for.

When I listed a property, one of the first questions I asked the seller was **"Why do you want to sell the property."** I wanted to attain the reason(s) and motivation of the seller so that I could structure the marketing and sale that would help him reach his goals.

One of the most common reasons a seller wants to sell his property is management. He is tired of tenants or he has negative cash flow that is killing him. Maybe he has a professional management company that is not doing a good job. Maybe he lives at a distance and can't oversee the property like he wants. Sometimes his motivation involves the dissolution of a marriage, partnership, or death.

Some want to sell to use the money for retirement, to help pay for a child's college, or purchase a new home. Another common reason to sell is to take his equity and move it into a larger property using a 1031 tax deferred exchange.

It bugs the heck out of me when I call another agent and ask the question: "Why is you seller selling the property?" and I get the answer "I don't know?"

Another question that I would ask an agent was, 'Will your client carry paper?" During some markets, carrying paper makes the difference between the sale of a property or not selling it. Again, many agents will answer this question "I don't know!"

So if I am the buyer's agent, I am thinking what things I can ask for that will benefit my buyer and what things can I give the seller to motivate him to give us these benefits.

If I am the seller's agent, what benefits can I get for him and still keep the buyer motivated to make the purchase.

WHAT TO DO IF THERE IS A COUNTER OFFER?

As I just mentioned, there are three things that the seller can do when presented with an offer:

1. Accept the offer
2. Counter the offer
3. Reject the offer

If the seller accepts the offer, you will start the process of moving to close the transaction which I will explain on the next page.

If you get a rejection, you have two choices.

- Forget about the property and move on
- Call the listing agent and see what the road block is and is it worth it to for you to try to overcome it.

When I receive a counter offer from the listing agent, I will review it with the buyer. We will see if the counter is giving us the benefits we want and still receiving an acceptable yield. Even if the counter offer gives us what we want, we still might consider coming back with a counter to the counter, trying for a little more. (Sometimes I will see 5 or 6 counters to an offer.)

Now, you might ask the question, is there ever a time when the agents would have the buyer and seller get together and try to negotiate the offer nose-to-nose. My answer is that I can only thing of one or two cases where I did this and I took into consideration the sophistication and demeanor of both parties. This usually does not happen. The buyer and seller might meet when the buyer is doing an interior inspection and the seller is there to open the doors.

You may have your agent suggest to you that you accept the counter offer from the seller. Of course, he wants his commission. You need to get feedback from your agent regarding the discussion of the offer and his feeling about making a counter.

Suppose you do make a counter offer back and the seller accepts it. You win some more benefits.

Suppose you do make a counter offer back and the seller rejects it. You can still go back and approve the first counter offer from the seller.

Be careful that you do not get too greedy and get in a position that the seller becomes upset with what you offered and won't respond to anything.

SO THE OFFER IS ACCEPTED – WHAT HAPPENS NEXT?

The accepted offer is a contract that explains the process that everyone will follow to allow the property to be transferred from the seller to the buyer and have all parties protected during and after the process.

This is where the fun (work) begins. There are already 3-4 parties in the transaction. The buyer and seller and the agents (they may be just one agent if the listing agent is also the buyer's agent.) Another party will be a neutral party to handle all the paper work and provide the title policy. In California we use escrow and title companies which may be the same company or different companies.

Remember in most cases, the buyer will have not inspected the interiors of the units before theoffer is accepted so the offer is blind in some respect. It is usual for the offer to be subject to inspection and approval of the interior of the units by the buyer and/or his agents and inspectors within **X** days of acceptance of the offer. There are usually several inspections that should be done including termite, roof, air conditioners, heaters, and home Inspections.

There are also several documents that the buyer should review closely to make sure that he has a good understanding about the property. This includes a rent statement, rental applications and agreements, estoppel certificates, and income and expense numbers.

Buying a rental property is like buying a used car. You can look at the exterior. You can look at the interior. You can even take it for a test drive. But unless you are a mechanic, it would be smart to have a professional inspection of all the systems so you know what the car is like mechanically.

If the buyer is getting a new loan, a loan officer from a bank, savings and loan, or credit union will be involved. They will also hire an independent appraiser to represent them.

The buyer and/or lender may require professional inspections and clearances done on the property. This may require the seller getting quotes and hiring contractors to do repairs.

There are lots of documents that must trade hands and be approved and signed by both parties.

Finally when all the "i's" are dotted and "t's" are crossed and the lender has transferred their funds to the escrow and the buyer has brought in their down payment money, the deeds are signed, the escrow company sends the lender's trust deed and grant deed from the seller to the buyer to the county recorder's office to be officially recorded and at that time, the buyer is the new owner of the property.

THE ORDER OF OPERATIONS

There is really a correct order to this process based on actions that are free and actions that cost money for the seller and/or the buyer.

Mixed in the pot are predetermined deadlines that are written into the contract for certain actions to be completed and in some cases approved by the buyer and/or seller.

Below are a list of items that don't cost money and a list that do cost money for either party during the escrow process. There will be additional costs from both parties to complete the purchase and close the escrow.

NO COST TO SELLER

- Interior inspection by the buyer
- Copies of rental applications and agreements
- Estoppel certificates
- Income/expense statement from the management company or owner's income tax statements on the property
- Signing paper work

NO COST TO BUYER

- Interior inspection by the buyer
- Filling out a loan application and providing required documents for lender
- Signing paper work

COST TO BUYER

- Loan application fee and credit report
- Inspections – termite – home inspection – pool - roof – heaters – air conditioners
- Appraisal fee

COST TO SELLER

- Doing repairs required by the lender or buyer

A smart agent will structure the offer so that the items that are done at the beginning of the escrow don't cost any money. This is what is called the discovery period where the buyer becomes more familiar with the physical property, the tenants, and the numbers associated with the property.

Also, a lot of these costs are negotiable where one party can ask the other party to pay. (Ex: inspections or some of the loan fees paid by seller or some repairs paid for by buyer.)

CHAPTER 17
THE ESCROW PERIOD
WHAT IS AN ESCROW AND HOW DOES IT WORK?

I remember when I first got my license and sold my first piece of property. My broker told me to go open the escrow. I had been involved with escrows when I had purchased property using other agent's but it seemed like all I did was sign where they told me to sign.

An escrow company is a neutral entity licensed to perform duties including helping buyers and sellers transfer ownership. They are to coordinate all of the required activities that will legally cause the transaction to be completed.

Most escrow companies are combined with title companies. Title companies research the property in escrow to determine what claims against the title there might be that may need to be paid by the owner upon sale. At close of escrow the title company provides a policy to the buyer and the lender, if applicable, that guarantees that there are no outstanding liens against the property except for the one's named in the policy.

In California, it is standard policy that the seller (seller's agent) would pick the escrow company because the seller purchased the title policy for the buyer which is more expensive than most of the other costs. Sometimes you will see a power struggle between the seller's agent and the buyer's agent on where to take the escrow because they each have their favorite.

After the contract to Purchase Agreement and any counteroffers are finally signed by both the buyer and the seller, one of the agents delivers them to the escrow company and the escrow officer incorporates the Purchase Agreement to what are called "escrow instructions." These instructions are to be signed by the buyers and the sellers and a copy would also go to the lender. It is then the duty of the escrow officer to work with the agents and lender to make sure all of the clauses (contingencies) are followed and completed. This would include collecting information from the seller (seller's agent) about the tenant' rents and deposits, any required reports such as termite which would be given to the lender, etc.

In most cases the loan documents are sent to the escrow officer to be signed by the buyers and the buyers are requested to bring in a cashier's check for their costs including down payment.

When everything has been done, the grant deed from the seller to the buyer and the trust deed from the buyer to the lender is taken to the county recorder's office and officially recorded. The property has now officially changed hands. The escrow company puts together a package of all the documents including the closing statement for both parties and pays checks to the seller and anyone else involved and hopefully everything ends happily ever after.

WHAT ARE THE NORMAL COSTS TO PURCHASE OR SELL A PROPERTY?

In a normal transaction involving residential income property, this is what was commonly paid for by each party.

Buyer

- Down payment
- 1/2 the escrow fee
- A title policy for the lender
- All loan fees and any discount points
- Appraisal cost
- Some preparation and recording fees
- Inspection fees
- Possibly some prepaid interest
- Possibly some tax prorations
- Insurance policy
- Money to be placed in the lender’s impound account if applicable

Seller

- Commission to buyer and seller’s agent
- 1/2 the escrow fee
- A title policy for the buyer
- Some preparation and recording fees
- Possibly some tax prorations
- Prorated rents
- Tenant deposits
- Transfer tax
- Natural Hazard Disclosure
- Pay off of existing loan(s)
- Repairs done to the property

BUYER'S NET SHEET

Buyer's Name(s) ________________________________

Property Address ________________________________

	Debit	Credit
Sales Price		
Deposit of Earnest Money		
ITEMS PAYABLE IN CONNECTION WITH LOAN		
Principal Amount of New Loan(s)		
Existing Loan(s) Taken Subject To		
Loan Origination Fee		
Loan Discount		
Appraisal Fee		
Credit Report		
Lender's Inspection Fee		
Assumption Fee		
ITEMS REQURED BY LENDER TO BE PAID IN ADVANCE		
Hazard Insurance		
Mortgage Insurance		
Property Taxes		
RESERVES DEPOSITED WITH LENDER		
Hazard Insurance		
Mortgage Insurance		
Property Taxes		
TITLE CHARGES		
Escrow Fee		
Lender's (ALTA) Title Policy		
Tax Proration		
Document Preparation		
Notary Fees		
Recording Fees		
Title Insurance Binder		
Rent Proration		
Tenant Deposits		
Inspections		
Termite Report		
Roof Report		
Home Inspection Report		
Miscellaneous Costs to Buyer		
Note to Seller		
Total Cash Paid by/for Buyer		

SELLER'S NET SHEET

Seller's Name(s) ____

Property Address _______________________________________

	Debit	Credit
Sales Price		
Escrow Fee		
Title Policy		
Tax Proration		
Documentary Transfer Fee		
Notary Fees		
Recording Fees		
NHD Report and Processing		
Commission		
Home Protection Plan		
Tenant Deposits		
Rent Proration		
Payoff 1st Loan		
Interest Owed 1st Loan		
Payoff Statement Fee		
Payoff 2nd Loan		
Interest Owed 2nd Loan		
Termite Clearance		
Roof Certification		
Repairs		
Note to Seller		
Cash to Seller		

CHALLENGES THAT ARE USUALLY CREATEDAFTER THE OFFER IS ACCEPTED

(Goal – find out the surprises as fast and as cheap as possibleand be prepared to try to solve them if possible)

THE DISCOVERY PROCESS

Another situation where you will see additional negotiation is after the price and terms have been agreed to and there are inspections done on the property for overall condition, roofs, electrical, plumbing, heating, and cooling, and termite. Sometimes the cost to do repairs is more than the seller wants to pay and he says he won't do some or any of the work.

Now a good listing agent can do a lot to help prevent these types of problems. He can order inspections paid by the seller before or during the listing period so that the knowledge of any problems and there costs will be upfront before an offer is accepted. If repairs are required as a condition of making a loan, sometimes the seller will accept doing the work because he knows that he cannot sell the property without completing the repairs.

I have had cases when a roof inspection determined that the roof could not be certified and needed to be replaced. If I represent the buyer, we would request that the seller pay to replace the roof. If I represent the seller, I will try to negotiate that the property is worth more with a brand new roof and because of this fact, the buyer should participate in paying for a new roof for the property at the time of purchase. Sometimes it will be worth it to raise the price of the property a few thousand dollars and apply some loan funds to the improvement.

Another problem that occurs during the escrow has to do with the appraisal. As the listing agent, I usually provide the appraiser with some comparable sells when I meet him at the property or I will ask him to contact me before he writes up the appraisal if he is having trouble justifying the salesprice so I could see what comps he is using and see if I know of any others that might help him.

If a roadblock happens in negotiations, it may be time to ask the agents to participate in some of the costs. Here is another time when you see who is really motivated. A smart agent who was my partner in my real estate office at one time taught me a powerful statement that I use quite often whenever someone tried to get me to reduce my commission or kick in some of my money to help close an escrow.

"MY COMMISSION IS NOT NEGOTIABLE"

Very rarely, unless it is just stupid not to, do I reduce my commission on a transaction. I try to always be in position where I am not the one that wants to win the most.

HOW ESCROWS DIE

Most transactions involve a buyer, a seller, and two real estate agents. For the escrow to close, all four of these people have to have integrity. Unfortunately, sometimes one or more don't.

Also, there can be lots of what you can call "influencers" that can screw up a deal. These can include friends and relatives of the buyer and seller, attorneys, tax consultants, and a whole slew of other individuals.

Knowledgeable real estate agents understand that in writing a contract, there are certain clauses that can be inserted called "subject to" or "weasel clauses." There are clauses for both the buyer and the seller to protect each party through the escrow period.

Another challenge that you have involves the paper work for purchasing a property. When I first got my real estate license, the contract that we used to write an offer was a legal sized, one-pagedocument.   Over the years, (due mainly to attorneys) it has grown to 10 pages along with extra pages of disclosures.

Most sellers are not even aware of the condition of the units inside. Since I have handymen do my maintenance, I very rarely enter my units.   Sometimes tenants do damage inside or have electrical and plumbing problems that they do not report to the owner. It is standard to have a clause in the offer that the seller will do all repairs "Subject to approval of the costs by the seller." If he doesn't approve the costs of the work, the seller would want to have the right to cancel or renegotiate the contract.

The bottom line is there may be a lot of negotiation between the buyer and the seller, even after the initial offer has been accepted.

PROTECTION CLAUSES - WEASEL CLAUSES

Examples for the buyer include:

Sale subject to inspection and approval of the interiors of the units by the buyer within X days.

Sale subject to buyer's approval of a rent roll, rental applications, rental agreements, and estoppel certificates provided by seller and approved by the buyer within X days.

Sale subject a "home inspection report" and "termite report" on the property to be provided by seller and approved by the buyer within X days.

Sale subject to the property appraising for the sales price of higher.

Seller to provide buyer with a 5-year roof certification.

Examples for the seller include:

Buyer to provide seller with a written letter of formal loan approval from his lender and proof of down payment within X days.

Sell subject to the approval by the seller of any costs of repairs required by the buyer and lender.

Sale subject to approval of seller's CPA within X days of acceptance of offer.

There is nothing wrong with using these clauses in good faith, and in most cases the buyer, buyer's agent, seller and seller's agent mutually want the escrow to go smooth and close promptly.

HOWEVER, there are times in the market when you want to make sure that you have ever "i" dotted and every "t" crossed. You want to make sure that everything is done in a timely manner based on the time limits outlined in the deposit receipt and escrow instructions.

Example: I had a buyer who wanted to purchase a fourplex to live in. We searched around and found one listed by another agent, who was the sister-in-law of the seller. We wrote the contract, opened the escrow and started the removal of the contingencies. One of the contingencies was not met by the day it was supposed to be due to a third party problem. What I didn't know at the time is that the listing agent had found her own buyer and knew if she could get her seller out of my contract, she would get a higher commission. Most agents work together and allow for some challenges as long as there is good faith by both parties. This agent decided that greed was more important. Needless to say, she was placed on my "DO NOT DO BUSINESS WITH AGAIN" list.

Example: I had a large number of fourplexes on the same block listed for a client. A buyer came in with an acceptable priced offer who was trying to complete the second part of a tax-deferred exchange. (You sell a property, take the proceeds and buy another property, close the escrow following certain guidelines, and you do not have to pay any taxes on the transaction.) Well as part of his sale proceeds on his down leg property, the exchanger had received a note. In his offer, the buyer told my seller that he would put enough cash into a side escrow so that as the escrow was closing, the buyer would purchase the note (replace the note with cash) and the seller would receive all cash. (This is a very simple and legal thing to do). Well the seller went to his uneducated attorney and was informed that this was really "risky" because "what if the escrow company didn't use the cash to buy the note and the seller ended up with the note instead." Of course he was too stupid to understand that the escrow company had to follow the instructions signed by both the buyer and seller or they could not close the escrow. Well, the attorney scared the seller so much that the transaction did not go through and I lost a very large commission.

The moral of this section is to have an agent who knows how to write an offer that protects you. If you discover something that makes you no longer want to purchase the property, make sure you find it during the discovery period. If you are happy with everything, make sure your agent responds in writing to the seller's agent within the time frame that you approve all your contingencies. Your offer should only allow a short period of time for the seller to cancel the escrow for things he is not happy with.

CHAPTER 18
THE LOAN APPROVAL PROCESS

Well, you have made an offer on a nice income property and the seller has accepted it. You have done your due diligence by having inspections done on the property and by looking at the paper work associated with the property such as rent roll, rental applications and agreements, estoppel statements, and the last two years of income and expense reports. You feel very comfortable about the transaction. The seller has signed the grand deed and you are ready to take title to the property. However, your partner, your lender, is not ready to close the escrow.

Since you made an offer that included obtaining a new first trust deed on the property, you must work with a lender to get your loan. The lender must also feel comfortable about the loan it is going to make on the property. It will focus on two different areas before it will give loan approval. These area are:

1. **THE BUYER**
2. **THE PROPERTY**

THE BUYER

The lender is taking on the responsibility of risking some of their investor's money to make a yield, some of which will go to their investors as a profit and some of which will be kept by the bank. (Art and Bill) Of course, the bank wants to have a secure position when they make the loan.

The bank is going to want to check your financial report card. They want to know:

1. Your credit worthiness by running a credit report.
2. Your income and work history
3. Your fixed expenses
4. Your assets
5. Your liabilities

You will normally give your lender a filled out loan application, 2 years of tax returns, and a schedule of real estate owned if you own other properties besides your home.

THE PROPERTY

You have done your due diligence in inspecting the property to make sure that it will provide the yield that you want. However, the lender still knows nothing about the property. To determine how much risk, if any, the bank will take, they will hire an appraiser to analyze the facts about the property and come up with a value for the property on which the loan will be predicated.

In most cases the lender will want the property to be in good shape with no deferred maintenance and with the premise that nothing major will happen to the property to jeopardize their equity position. This includes that the roof is in good condition, the appliances still have some economic life, the foundation is firm, and that there are no termites causing damage to the property.

HOW PROFESSIONAL APPRAISERS EVALUATE A PROPERTY

One of the things that a person learns when studying to get their real estate license is a little about the appraisal process. Of course, sellers will ask an agent to determine what they could sell their property for if they listed it and a buyer wants to know what a property is worth from his agent before he makes an offer.

An appraisal is an **opinion** of value. Depending on the property, you could have three different appraisers come up with a value that could be quite a bit apart. Most appraisers specialize in single family homes. Usually, there are only a few appraisers in a city that really understand residential income or commercial property appraising.

An appraiser is usually hired by the lender and in most cases the buyer pays the cost. When appraising a single family home, the appraiser uses two different methods to come up with the value.

1. The first method is called the **comparative approach** and is usually weighted higher. The appraiser searches the local market for homes that have sold that have the similar amenities as the subject property. Location, square footage, number of bedrooms and bathrooms, size of garage, pool, lot size, etc.
2. The second method is called the **reproduction or cost approach**. The appraiser uses current data provided by the building industry to determine the price per square foot to build a new house identical to the existing house. He then discounts a certain amount for depreciation caused by the age of the improvements and wear and tear.

For multi-family properties, the appraiser will use these two methods plus a third approach.

3. The **income approach** involves determining the income and expenses of the property and then the net operating income. They then determine the cap rates for similar properties that have already sold with the same physical characteristics. Next they take the average cap rate and multiply it times the net operating income of the property being appraised. This would give them the value of the property they are appraising.

This is the same process that we have been teaching you throughout this book.

WHAT ARE THE POSSIBILE RESULTS THAT CAN HAPPEN WITH THE APPRAISAL?

The appraiser does not work for the buyer or the seller. He works for the bank. His purpose is to protect the bank's security interest in the property. Different results can happen when the appraisal is done.

1) The appraisal value will be less that the sales price.
2) The appraisal value will be the same as the sales price.
3) The appraisal value will never be more than the sales price.
4) The appraisal will have no work contingencies for the property.
5) The appraisal will have work contingencies for the property.
6) The property may be disapproved for a loan because of its physical condition.

WHAT ARE SOME WAYS TO SOLVE THE PROBLEM OF A LOW APPRAISAL?

Let's take another scenario. Let's say that a property sells for $125,000 the appraiser thinks the property is worth only $120,000. Now the bank will only lend 80% on the $120,000. Instead of a loan of $100,000, the buyer can only get a loan of $96,000, $4000 less. What could happen?

- If he is really motivated, the seller could reduce the sales price to $120,000.
- The seller could refuse to sell at $120,000 and still want $125,000. The buyer could either:
  - add additional cash to the transaction, or
  - start over with a new lender and get a new appraisal from a different and hopefully, a more liberal appraiser.
- The transaction could be cancelled.
- The seller may say that he will reduce the price down to $120,000 if the seller's and buyer's agents reduce their commissions by a certain amount, say $1000 each.

Oh, oh! Now we are in a position that measures the motivation of other people beside the buyer and seller. If the market has been tough, both agents may very well discount their commissions. We saw when the market was really hot, that agents were listing for a lot less that 6 or 7% commission and companies like Help-You-Sell became more popular.

Your agent doesn't want you to know this, but to save a transaction and get something for his effort, he may be willing to contribute to the pot to solve a problem.

WHAT YOUR LOAN OFFICER DOESN'T WANTYOU TO KNOW ABOUT APPRAISALS!

The appraised value will never be higher than the sales price.

Let me tell you a secret that you should be aware of. Let's say a property is listed by a seller for $130,000 and a buyer makes an offer of $125,000 that is then accepted by the seller. The buyer's bank hires an appraiser to determine the value of the property. It is the responsibility of the appraiser to protect the bank and make sure that the loan is a safe investment. The bank wants a certain amount of equity in the property above the loan amount.

Example: The sales price is $125,000. The buyer is getting an 80% loan to value on the property, $100,000. The bank wants there to be a 20% equity position above the loan at the close of escrow, $25,000.

If the property appraised for $120,000 and the lender made the $100,000 loan, then there is only 16.7% equity above the loan. The bank would reduce the loan amount to $96,000.

BUT WHAT HAPPENS IF THE APPRAISER THINKS THE PROPERTY IS WORTH MORE THAN THE SALES PRICE?

What happens if the appraiser comes up with a value higher than the sales price, say $140,000 for the property? Will he inform the buyer, seller or agents? **The answer is "NO!"** The appraiser will appraise the property for $125,000. Why? Because the appraiser works for the bank. His responsibility is to **determine if the property is worth <u>at least</u> the sales price.**

As the buyer, you would know that the property is worth <u>at least</u> $125,000.

WHY WON'T THE APPRAISER OR BANK REVEALTHE HIGHER APPRAISED VALUE TO THE BUYER AND SELLER?

What would happen if a property sold for $125,000 and the appraiser wrote the appraisal for $140,000?

The seller would probably want to renegotiate the sales price with the buyer and it probably would cause the deal to fall apart. Who wins in this case? Maybe the seller can put the property back on the market and sell it for the higher price. But the buyer, the buyer's real estate agent, and the bank all lose.

It also makes the listing agent look like an idiot for listing the property for less than its true value. Banks want to have a working relationship with agents and brokerage firms and if they make them look bad, the bank will lose their business.

As I got to know the lenders and the appraisers, I could see that somewhere more liberal in their lending terms and their choice of appraisers. At times, there were lenders and appraisers that I refused to work with and if a buyer's agent brought in an offer, I would question him before he made the offer, who he planned on using to get the loan. There were times that I convinced him to switch lenders to increase our chances of a successful close of escrow.

Another interesting thing happened as I became more experienced and started dominating the market for residential income property. I had more and more transactions close. When an appraiser was looking for comparable sells, he or she would often call me to ask questions about a property I had sold or if I knew of any properties that sold that were not listed in the MLS (Multiple Listing Service). I got to know them better and they developed more respect for me and my opinion because of my experience.

This is an advantage that a knowledgeable salesperson has over less experienced and less successful agents.

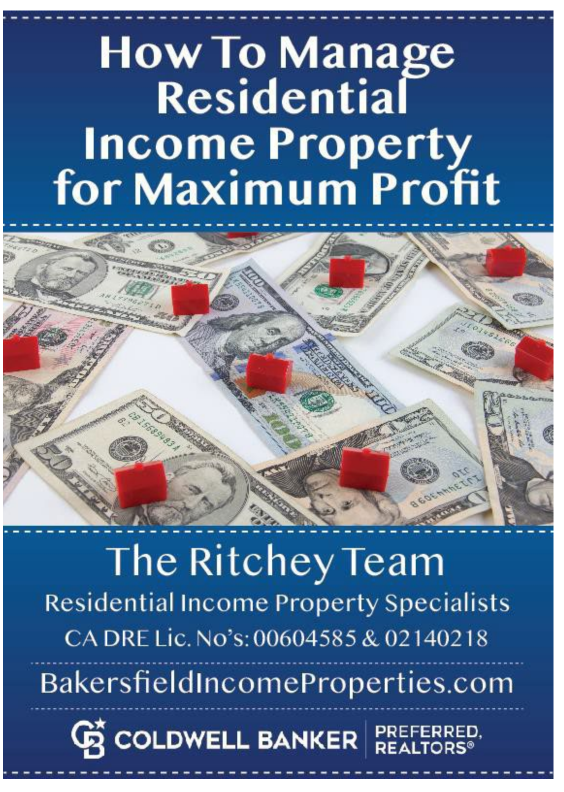
CHAPTER 19
THE OWNERSHIP PERIOD BEGINS

Well, you have been notified that the escrow has closed and you are now the owner of your first rental property. What do you do? It's almost the same as you getting a call from an attorney who informs you that a rich aunt had died and willed you a McDonald's Restaurant that she owned. You better figure out pretty fast that you need some education very quickly.

For the McDonald's Restaurant, you will probably immediately enroll in their hamburger college and have them educate you.

For your rental property, you should have already been reading as much as you can about the management process. I am prejudice, but I strongly recommend you start with my book "How to Manage Residential Income for Maximum Profit." Even if you are going to have a professional management company take over the property, you still need to know information about the management process. Remember, I have taught you not to trust poor people and salespeople when you purchase residential income property. This is also true when it is time for management. You wouldn't inherit the McDonald's Restaurant and just tell the manager to carry on and send you the check each month.

Remember, ignorance is not bliss!



CHAPTER 20

SOME OTHER IDEAS I WANT TO SHARE WITH YOUWHEN PURCHASING A PERSONAL RESIDENCE

I want to share some ideas regarding the purchase of an owner-occupied single family home by an individual. First of all, after a person decides he wants to buy a house, he will start talking to real estate agents and a smart agent will refer him to a loan officer to get prequalified. Now the loan officer will get all the information from the buyer and based on the different factors, will come up with a <u>maximum payment amount that the buyer could be qualified to pay</u>. Based on that and the interest rate, a maximum loan amount could be determined. The down payment would be added to the loan amount to give a total sales price the buyer could pay. Next, the buyer jumps in the agent's car to

Example: Mike decides that he wants to buy a home so he goes to a lender and submits his loan package. He has $10,000 for a down payment and can qualify for a $165,000 loan at 7%. Mike's real estate agent makes a list of all the homes for sale for $165,000 to $185,000 that are located in the areas that Mike likes and they start going out and looking at the properties. Mike finds a house that he likes that is listed for $182,995 and makes an offer for $175,000. The offer is accepted and Mike closes escrow on his new house.

This is an example of a typical real estate purchase.

But what doesn't Mike's agent and loan officer discuss with Mike before he starts looking for a house?

First of all, Mike and his agent might spend a little time discussing the state of the market. Is now the best time to consider a purchase? Are property prices in a relatively low price range or are they close to the top of the market? Where are prices heading, up or down? Would it be smart to continue renting for another year or two instead of purchase at this time? What are the interest rates at this time and what is likely to happen to them in the future?

Now, would it be in the best interest of the agent and the loan officer to tell Mike to wait a little while before buying?

Let's say it is a good time to purchase. Another interesting discussion that might take place has to do with the price of the home that Mike wants to buy.

In our example above, Mike got a $165,000 loan at 7% interest for 30 years. His payment will be $1097.75 per month. He will also have to pay taxes and insurance.

Of course, most buyers want the biggest house they can afford at the time and are not thinking about the future. Their Belief Window has nothing about Winning the Game of Money on it at this time.

Is a personal residence an asset or a liability? Does it put money in the owner's wallet or does it take money out of the wallet? It's a liability! Now what would happened if Mike's agent told him that instead of purchasing a $175,000 house, Mike should reconsider and purchase a $140,000 home. The loan amount would be $130,000 and the payment would be $864.89. That would be a payment reduction of $231 per month. Also Mike's taxes and insurance would be less. Let's say the total payment reduction is $300 per month or $3,600 for the year. What would be an option to do with the extra money? How about save it along with additional income from Mike's pay check and eventually buy an investment property. Then save up some more money and buy another property and continue to do this until Mike owns as much rental property as he wants to.

I don't think there is a real estate agent or loan officer in the country that would ever have this type of discussion with you except me.

What is on your Belief Window regarding delayed gratification and buying assets? I hope I have been able to change some of those beliefs to help you succeed and Win the Game of Money.

HOW TO LIVE FOR FREE

Outside of taxes, most family's top expense is for shelter. About 40% of the U.S. population pays rent to a landlord. Most homeowners in the country pay a mortgage payment and they all pay taxes and insurance.

First of all, let me give my definition for "Live For Free." It is you and your family living in a home where you do not have to pay any rent, mortgage payment, taxes or insurance for your residence. These expenses are paid with passive income from assets that you own.

There are three ways you can do this, all of which I applied in the late 1990s and early 2000s.

METHOD A

BUY A RENTAL PROPERTY AND LIVE IN IT.

Personally, I think that best property to start with is a fourplex. You will have 3 units that will generate rent for you to pay your expenses. Of course, this would work even better with more units but as we have discussed, the financing on an owner-occupied fourplex is a lot better than that of 5+ unit with a commercial loan.

In 1997, I purchased a nice fourplex in a good area of Bakersfield within walking distance of an elementary school. The purchase price for the fourplex was $167,500. There was a 3 bedroom 2 bath master unit with a fireplace, and two car garage, and about 1300 sq. ft. The other 3 units were 2 bedroom, 1 bath, with 900 sq. ft. and garages. I bought the property with an owner-occupied FHA loan and my down payment was about $8000. My loan amount was $159,000 and the payment was $1201, principle and interest. My taxes and insurance were included in my payment. Taxes were $203 per month and insurance was $92 for a total payment of $1496 per month PITI (principle, interest, taxes and insurance). I rented the other 3 units and my total income was $1485 which almost covered my payment.

Now you may say what about water, trash, gardening, maintenance, etc. Well, remember that 3/4ths of the property is considered rental property and I could depreciate them for a loss. In this case my depreciation for a year was $4353. My tax saving paid for these additional expenses!

Now that I was living for free and had some extra discretionary income, what do you think I did with it? From 1998 to 2000, I purchased additional rental properties.

METHOD B

PURCHASE ENOUGH RENTAL PROPERTIES SO THAT THE CASH FLOW PAYS YOUR MORTGAGE PAYMENT

Another way to "Live for Free" is to purchase a home to live in and also purchase additional rental units that will provide enough cash flow to make the payment on your home.

After living in our fourplex for three years, my wife asked me if we could purchase a home to live in. During those three years we had purchased an additional 55 rental units. We found a very nice 4 bedroom home with a swimming pool on Bridlewood Lane, got a new loan and closed escrow. We rented our old unit in the fourplex for $650. We had more than enough cash flow that our tenants paid us to allow us to live for free plus lots of extra income for a very nice life style.

METHOD C

BUILD UP ENOUGH EQUITY IN YOUR PORTFOLIO THAT YOU CAN SELL SOME PROPERTY AND PAY OFF THE LOAN ON YOUR HOME

So far I have explained two methods that I used to “live for free” by purchasing an apartment complex and living in one of the units and also purchasing enough cash flow properties that the tenants paid my mortgage on my home. The third method I want to explain can be applied usually only after owning some property for a period of time. As you build equity by loan pay down and appreciation, you might be in a position to sell one or more of your investment properties for cash and then pay off the loan on your personal residence or even purchase a new home with your proceeds.

In 2003, I sold a 10-unit complex on K Street and paid off my home on Bridlewood.

In 2004, because of the extraordinary increase in values, I saw an opportunity to sell some of my properties for a large profit. I decided that it was time for me and my family to move up to our dream house in the mountains. We had a nice condo in Mammoth Lakes, California but there was not much of a town there and it was not close to a large metropolitan area. We started looking at property in both Incline Village, Nevada and South Lake Tahoe, California. We decided that we liked South Lake Tahoe better and so we found a real estate agent who started showing us some of the homes for sale. (Even though I was a licensed real estate broker, I had no knowledge of the Tahoe market, and the different disclosures that are needed so I was willing to let another agent receive the commission instead of trying to do it all myself.) At the same time I put up four of my investment properties for sale. One of the properties was my condo in Mammoth. Another was the fourplex that Vicky and I had purchased to live in when we were first married. I also sold a little bread and butter six-unit and two houses on one lot. I had purchased all of these properties between 1997 and 2002. My net proceeds were over $1,000,000. With these funds I paid cash for my home in Lake Tahoe. At the time, I still owned my home in Bakersfield which was free and clear.

On the next two pages is an article in our local newspaper that was written about me when I applied the LIVE FOR FREE method for my family.

DAN OCAMPO / THE CALIFORNIAN

Bob and Vickie Ritchey, with 1-year-old Michael, stand in front of their four-unit apartment building.

Unit $weet Unit

Real estate broker devises a plan to 'live for free' by buying a small apartment complex and living in one of the units

By JAMES BURGER
Californian staff writer
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Bob Ritchey has been paying off his debts and saving more cash for retirement since he stopped writing a $750 rent check every month.

In place of rent, he picked up a $1,496 payment for mortgage, insurance and taxes on a four-unit apartment complex. He's been in a better financial situation ever since.

Ritchey, a commercial real estate broker, has developed a sales program designed to help other people duplicate his experiences.

He calls it "Living for Free."

It's a simple idea that Ritchey is sure has been around for decades. Other agents offer similar commercial income properties.

All Ritchey is doing is marketing the idea a little bit more aggressively.

There are three steps to "Living for Free":

• Buy a small apartment complex — Ritchey says four-unit complexes (or fourplexes) work best because they take minimum management for maximum income.

• Move into one unit.

• Rent out the other three units.

As an example of how this would work, Ritchey presents himself.

He has lived in the three-bedroom, two-bathroom master unit of his fourplex on North Laurelglen Boulevard for almost two years.

Ritchey pays $1,496 for the fourplex each month and collects $1,485 in rent from the tenants in his three other units.

Net monthly cost to buy the fourplex — $11.

Of course, that doesn't include all of his utility and maintenance costs or protect Ritchey if one of his tenants doesn't pay rent.

But, when things work right, Ritchey lives in his home nearly free of charge.

While the Living for Free concept is simple, Ritchey said the plan has complications.

"When you are buying a rental property, you're buying a business and you need to treat it like a business," he said.

It's important for property owners to be aware of how insurance issues impact their property, what taxes they are responsible for, tax breaks available to them and how tenant problems can impact their profitability, he said.

But several tax issues can make it easier to live for free in a fourplex or other residential income property, Ritchey said.

On all units the owner does not occupy, expenses like water, electricity, maintenance and landscape services can be used as tax write-offs.

That includes depreciation on the property, an equation that zeros the value of property improvements (i.e. buildings) over the course of 27½ years.

Depreciation is a paper loss that is deducted directly from the owner's income on the property — which lowers the amount of money the

Please turn to APARTMENT / C4

APARTMENT: Owner gets tax write-offs

Continued from C1

owner pays taxes on.

But the live-for-free concept is not for everybody.

David Nicholas, a certified public accountant with Daniells, Phillips, Vaughan and Bock in Bakersfield said investors considering the purchase of any residential income property should look hard at the bottom line of the deal.

"It can be made to work, but you've got to run the numbers," he said.

He advises people to find an experienced real estate agent to help them locate the right property and contact their accountant to find out the exact tax impact.

Then make sure the property will turn a profit, he said.

Ritchey said he is motivated by the profit he makes on his property.

"I'm doing this to get out of debt and build my retirement income," he said.

But the apartment Ritchey shares with his wife and infant son will not be the family's permanent home.

An investor can buy the nicest complex on the market, he said, "but you still won't find all the amenities of a stand alone (home)."

Investors need to think seriously before diving into the deal.

"They have to make a decision that this is not going to be their dream property," he said.

And, he added, investors also have to be willing to take on the responsibility of advertising, interviewing and managing tenants for the property.

Oscar Rudnick, president of the Kern County Apartment Association, said tenant screening is critical to keeping rental property profitable.

Rudnick, who manages 150 units with City Wide Property Management, advised new landlords to research the employment history, credit history, rental history of prospective tenants.

He even suggested stopping by the applicant's current home to get an idea of how they maintain property.

But, Rudnick said, instinct also plays a part in a landlord's decision about who they will rent property to.

In an interview, an experienced landlord can get a feel for the kind of renter an applicant will be.

Rudnick said those instincts can often be trusted, unless the landlord hasn't had much experience with evaluating other people.

Once the tenant is in the property, Rudnick said, things sometimes go wrong.

The landlord should document complaints from other tenants, record damage to the property and then give the problem tenants a chance to change their ways by talking with them.

Follow up with a formal letter, he said, and if problems continue, give a three- or 30-day notice to move the offending tenant out of your property.

Issues like these are what investors should seriously consider before becoming rental property owners, Ritchey said.

In the last year, Ritchey has had a handful of clients consider his Living for Free program and decide to go for it.

He says now is the perfect time for investors to pick up residential income property.

Property prices in Bakersfield are low, but there are a number of good properties on the market.

Richard Gill is one of the people Ritchey has introduced to residential income properties.

"So far it's worked pretty good for me," he said. "I would recommend it to other people."

Gill lives in one of the units of his fourplex on La Costa but his railroad job runs out of Oakland.

Since he is constantly on the move around the state, the fourplex gives Gill the chance to maintain a home base in Bakersfield, where the cost of living is low.

Gill made a $9,500 down payment on his $180,000 property and pays $1,547 each month in principal, interest, taxes and insurance.

Each month he also collects $1,550 in rent payments.

That profit stream from the property keeps the overhead on his home base low. He has a cheap place to stay for the three or four nights every week that he is in Bakersfield.

"The rent from the units are paying my payments, insurance and taxes," he said.

He pays a little money to have a gardener maintain the landscaping and has hired a property management firm to handle the administration of the property.

But Gill is nearly living for free.

THE SMART INVESTOR'S METHOD TO PAY FOR A LIABILITY

I want to share something else that happened during those three years between 1997 and 2000. Remember we defined an asset as something that creates cash flow and a liability as something that costs you money every month.

I love the mountains. Bakersfield is hot and the air is dirty. When I went to the beach I got bored within a couple of hours. But the mountains were great. I loved to hike, fish, and ski. I love the smell of the mountains and the ability to look up at the ski at night and see thousands of stars.

In 1983, things were going well for me, both from my commissions and from my rental properties. I decided to purchase a home in Mammoth Lakes, California, (a big liability). It was a beautiful property with 5 levels, a pool table, a loft area, and nicely furnished. It was one of my big dreams come true. My family would go up during holidays and for most of the summer. Then in 1986, when everything fell apart, I had to sell the house or lose it to foreclosure. Luckily, I found a buyer. But I always dreamed of having my home in the mountains.

In 1998, I took my new wife, Vicky, and our two boys and we rented a condo in Mammoth for a few days. I wasn't sure how Vicky would like the mountains and the snow because she is from Guadalajara, Mexico, and they don't see snow down there. We made one more visit to Mammoth and then I asked Vicky which would she prefer, purchase a home in Bakersfield and move out of the fourplex or purchase a property in Mammoth and stay in the fourplex. Well, my loving wife gave me the answer I wanted, she voted for Mammoth.

We found a very nice condo with two bedrooms and a loft that we liked and so we purchased it. Now here was the difference between 1983 and 1998. The condo had professional management that allowed us to put our unit in a rental program and generate some income. This covered some, but not all of the costs of ownership. But I had plenty of extra cash flow from my rental properties, so in fact, my tenants helped me pay for the expenses of having my condo. It was a "Live for Free" situation also.

Robert Kiyosaki gives an example in one of his books. He wanted to buy a fancy new car (liability) and he had the cash to do it. But his wife, Kim, who is also financially intelligent, encouraged him to go buy an asset with the cash, and use the cash flow from the asset to make payments on the car. When Robert decided to get rid of the car, he would still own the asset.

Now, I am not encouraging you to use your cash flow from your first few investments to run out and buy a liability. You need to have self-discipline and delayed gratification. If you have the patience to keep rolling your cash flow into more and more properties, you can Win the Game of Money with enough residual income to pay your ordinary expenses plus have a lot left over to spend on liabilities and doodads.

A UNIQUE PLAN OT PAY FOR A CHILD'S COLLEGE EDUCATION

In today's society, it is becoming more evident that a college education is more important than ever. The income gap between high school graduates and college graduates has been growing steadily.

Even if your eldest is still wearing diapers, the time to start saving for college is now. Nationally, the average cost for four years of tuition and expenses at a state-run school today is more than $40,000. Assuming that costs continue rising 5% a year, the same education will add up to $104,000 when today's babies trot off to college 18 years from not. Degree programs at the nation's best private schools could easily top $400,000 by 2015 or 2020.

Very few families can really afford this cost and so children will go to junior colleges for 2 years and/or take out school loans that they have to pay back after graduation. Many will get part time jobs, reduce the amount of classes they take each semester, take longer to graduate and increase the dropout rate.

I would like to suggest an investment plan for you to consider for your child's or grandchild's college education.

Let's say that you want $75,000 when the child is 18. When the child is born purchase a residential income property, say a duplex, for $75,000. It will cost you somewhere between 5% and 20% as a down payment. Determine what the payment amount would have to be to amortize (payoff the loan) in 18 years. Make sure that they property has enough income to pay all expenses including the loan payment. Keep track of your tax benefits, after a few years you will probably have your initial down payment back from tax savings. Your tenants will pay rent which will purchase the property for you.

When the child reaches 18, you will have the property free and clear. Chances the property will be worth more than the $75,000 purchase price. You can apply the cash flow to the college expenses, sell the property (taxable event) or refinance the property (non-taxable event) to cover school costs.

ANOTHER PLAN FOR YOU TO CONSIDER

Let's say that besides purchasing the $75,000 duplex when the child is born, you also purchase $150,000 fourplex. You set up the property payments to amortize over 25 years.

When the child is 25 and you feel he or she is mature, you sell or refinance the property and purchase the child a free and clear home. Owning a home without mortgage payments will allow them to have a lot better life style and hopefully they will apply the same techniques for their children.

HOW I HELPED ONE OF MY SONS BUY HIS FIRST CAR

One spring around 1992, I got a call from some clients of mine that owned a rental house in a bread and butter area of town. They lived out of the area and were having trouble managing and maintaining the property and wanted me to sell the property. The property was vacant at the time.

After looking at the property, I could see that the property needed a lot of work; a new roof, painting inside and out, new carpet, cleaning up of the yard, and a lot of miscellaneous repairs. It would be very hard for a buyer to get a new loan from a lender with the current condition of the property. Also, they really didn’t have any equity as the property was worth about what the loan amount was.

At the same time, my teenage son, Brandon was trying to find a way to make some money to purchase his first car. I took him out to the property and we discussed a proposition. I would put up the money to fix up the property; he would do all the labor that he could do. (I had a professional roofer put on a new roof, and professional painter paint the exterior.) Also carpet was installed by a carpet company). Brandon would spend each day during the summer doing what he could do until the project was done. When we sold the property, I would be paid back my initial investment and then he would be paid the profit.

I told the owner’s that I would take control of the property and pay the expenses until the property was fixed up and sold. I would pay the costs of sale so that they would not have to come out of their pocket. The owners were very happy with this agreement.

Well, we started on the property and I had a few struggles convincing Brandon to get to work, but he ended up doing a good job.

It ended up that Brandon learned a lot about repairing a property, saw how a fixer-upper worked and made about $4000 from the transaction. He made a lot more than if he had gotten a regular job, learned about self-motivation, and got his car.

YOU'VE WON THE GAME OF MONEY! CONGRATULATIONS! WHAT NEXT?

One of my favorite questions that I ask people is "What is your exit strategy from your job or profession? The Win the Game of Money Institute is dedicated to helping people answer this question by teaching effective plans that they can apply to realize their goal of a successful exit strategy.

This book has been dedicated to explaining how you can Build a Real Estate Money Machine to Win the Game of Money. Let's say that you have applied the principal of developing cash flow assets over the years and your Wealth Ratio is equal to or greater to 1. You've won the Game of Money? You have enough passive income to pay your expenses and live the life style that you want without working. You are Financially Independent. Congratulations!

I would like to spend just a few minutes discussing what's next once you have won the Game.

I've always thought that it would be smart to continue playing the Game well beyond just financial independence for several reasons:

1. The higher my wealth ratio, the more insurance I have in case of some financial disaster such as recessions, changes of tax laws, inflation, the destruction of the dollar. A wealth ratio of 1.5 or more will make anyone feel more secure.
2. Extra cash flow can mean a better life style. But it can also mean money to help family members or to make donations to charities or churches.
3. You may love playing the game and have high goals of becoming very wealthy.
4. You can put your properties into a trust and strive to pass on the income in perpetuity for your family or other organizations.

Example: You feel comfortable living on a gross income of $80,000 per year. Try to continue to build the cash flow. Take the extra income and either purchase additional assets or apply the money to debt reduction on the assets you own.

What are some options that you can do if you just want enough for you and your spouse to live out your lives but you don't want to continue worrying about the management of your real estate assets? You may want to get out of the active ownership of income property. There are a few ways that this may be accomplished:

Of course, you can just sell your properties for cash, pay your taxes and either live on the proceeds or invest them in some simple interest bearing asset and live off the interest. If you own several properties, you can sell one every few years and live off the proceeds.

You can also sell some of your properties, take the proceeds, and pay off the loans on other properties which will increase your cash flow.

You may sell your property to a buyer with a substantial down payment and carry a loan back on your property that would include some principal reduction along with interest. This would qualify you for what is called an **installment sale** where you pay ordinary taxes on the interest, but capital gains on the principal that your receive each year. This has the effect of spreading your gain over several years and may save you some considerable money in taxes. You would want to check with your tax accountant at the time to see what the tax laws are at the time.

Another idea is to package your properties together and do a tax deferred exchange into one large property with a resident manager.

You may apply the plan of refinancing one of your properties every each year and live off the net proceeds of the loan. This currently is a non-taxable event.

As you grow older, you may want to gift some of your property to your children and charitable organizations or churches. There are programs that allow you to donate your property to a charity, and the charity pays you the cash flow until you die.

These are some of the things you will be contemplating as you get close to winning the Game of Money.

SUMMARY

- If your goal is financial independence, you must develop enough passive or residual income to pay your ordinary expenses.
- You cannot become financially independent spending all of your money.
- You must become knowledgeable about businesses and investments.
- Remember the Art and Bill model. Earn a higher yield than you pay and you make money on borrowed money.
- Purchase property with high leverage as long as it has cash flow.
- Don't count on appreciation!
- Learn the prices, expenses, and rents of properties so you can make an accurate analysis and intelligent decision.
- Become an expert in management.
- Know your yield. Check in regularly.
- Surround yourself with experts in the areas that you will need. (Real estate agent, insurance agent, lender, accountant, attorney, inspection people, maintenance people, fellow investors.
- Have patience. Real Estate is not "get rich quick."
- Have multiple streams of income.
- Your goal should be to buy residential income property with the best yield, in the shortest period of time, with the least down payment.

THE LAST THING I WANT TO LEAVE WITH YOU

Well we have spent a lot of time together and I hope you have understood the principles that I have taught you in this book and my video course on **How to Build a Real Estate Money Machine,** buying properties for cash flow using the Art and Bill Model.

We have talked about the importance of your mastermind group. This group will include at least one real estate agent that specializes in residential income property, one or two loan officers, and several investment gurus.

When picking your mastermind group, be careful to look for this one important concept. **Are they showing you how to become an investor or a speculator?** If the real estate agent and the guru are talking to you primarily about appreciation, get rid of them. Find a new agent and throw the guru's information in the trash. If your loan officer is trying to convince you that a 15-year loan is better than a 30-year loan, get rid of them.

Your time and your money are too valuable to work with the wrong people.

You can find more information of investing in residential income property by going to:

www.BakersfieldIncomeProperties.com

If you have any questions or if I can help you in any way, please feel free to call me at:

(661) 332-4716

Or email me at:

Bob@TheRitcheyTeam.com

I TRULY WISH YOU SUCCESS IN YOUR JOURNEY TO WIN THE GAME OF MONEY!

Bob Ritchey