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 <u>NOT</u> 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 of 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 of 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.

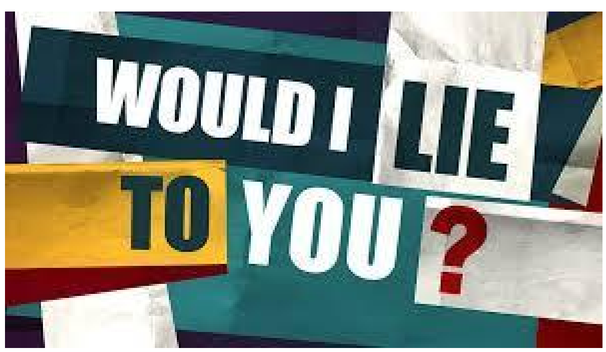
If we rent the unit for $600 for one year we would collect $7200. If we have one month free, we lose $600. $600 divided by $7200 is 8.33% vacancy.

The "move-in special" that I like to use has to do with the amount of deposit. If the deposit was $800, 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

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 assume that everything that was written on the application is a **LIE**!



The applicant 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 **<u>quality</u>** 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 Property for Maximum Profit" book. If that won't work, start the eviction immediately unless you have confidence the tenant will come up with the rent.
4. Get a strong co-signer. (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 than 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 Fortune 500 company. Usually the owner would have to give up some of the Quantity, by offering lower than market 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 SCENARIO

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 **<u>Quality</u>** 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.**