MAKE MONEY

with

FIXER-UPPERS AND RENOVATIONS

GARY W. ELDRED, Ph.D.

WILEY

John Wiley & Sons

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CHAPTER 1

Your Quick Path to Profits:
The Entrepreneurial Approach

Would you like to double or triple your money in 12 months or less? Would you like to build quick profits of $10,000, $20,000, or $50,000—even though you lack cash or strong credit? Do you want to learn a money-making skill that you can put to work anywhere in North America (or for that matter, anywhere in the modern world)? Would you prefer to work full- or part-time without set hours and without a boss looking over your shoulder? Would you like to achieve mid- to long-term financial freedom and personal independence?

If you've answered yes to any or all of the preceding questions, then this book's for you.

In this book, you will learn how to earn big profits as you entrepreneurially create value for the buyers and tenants of your properties.

To maximize profits, entrepreneurs strategically improve their fixers.

As a real estate rehab entrepreneur, you will search out properties that offer opportunity for profitable improvement. But you won't just slap on a fresh coat of white paint, lay down new beige carpet, and wash the windows. You will *strategically* improve the property to favorably distinguish it from its competitors. You will explicitly shape its features toward a select and profitable target group of buyers or tenants. You will work with your mind, not necessarily your hands.

As you follow this strategic approach, you will learn how to ferret out those properties that offer the most profitable potential for change. You will discover how to create synergy: The value of the whole improved property will greatly exceed the sum of the parts (your input costs).

The Entrepreneurial Difference

Profit with the entrepreneurial difference.

Amazingly, no other book on "fixers" adopts an entrepreneurial approach. Other authors tout fixers because you can often buy these properties at a bargain price. In fact, in his best-selling book *Buy It, Fix It, Sell It, PROFIT!* (Dearborn, 1998), Kevin Myers writes,

> Some real estate authors have perpetuated the myth that the desirable return on rehab is anywhere from $2 to $4 for each rehab dollar invested.[1] Under this theory [sic], a $1,000 investment in rehab would increase the value of the house by $2,000 to $4,000. This is both preposterous and irrelevant to the rehab investor. (p. 149)

Myers then reprints figures from an article in the *Wall Street Journal* that ostensibly shows that paybacks from rehab or remodeling typically yield returns of only 30 percent to 80 percent of the amount invested. "Just glancing at these [figures]," Myers says, "You can come to only one conclusion: Remodeling a house is a losing proposition" (p. 149).

1. I am one of those authors (see my *Investing in Real Estate,* 4th ed., Wiley, 2003, pp. 165–186), but my analysis is neither "myth" nor "theory." It derives from reason and experience.

In fact, if you will take the time to work through the "fix-it" examples that Myers presents in his book, you will see that he made money only because he supposedly bought properties for 60 cents on the dollar. True to his word, he makes no profit from the property improvements themselves.

The "Bargain Price" Approach

Unfortunately, if you do adopt the bargain price approach favored by Myers and other "fix and flip" authors, you most likely will either fail or you will get yourself involved in fix-it work that does not add even one cent to your profit.

The Path to Failure To follow the bargain price technique, you are told to locate motivated sellers with problem properties (the right things wrong). Ideally, if the current as-is value of a property totals $90,000, you take advantage of the seller's distress and "steal" the property for, say, $60,000. Next you put in $30,000 to cover the costs of acquisition, fix-up, and an eventual sale at $120,000 (the property's market value as improved). Accordingly, you exit the deal and pocket $30,000.

Sounds pretty good until you realize that your total profit hinged on buying a $90,000 property for $60,000. Now ask yourself, why would a distressed (motivated) seller be willing to leave $30,000 on the table? Yes, $5,000, maybe $10,000, on occasion even $15,000 or $20,000—but you will rarely find discounts and bargain prices that even come close to those amounts suggested by Myers and other like-minded authors.

Contrary to the hype, you will rarely find sellers who will give you a 30 percent or 40 percent discount.

Moreover, many (perhaps most) motivated sellers are drowning in debt. They cannot offer you a steep discount because they owe nearly as much (if not more than) their property is worth. On occasion, in depressed housing markets, lenders will accept short payoffs. But these deals generally require much time and trouble. It's best to pursue them only during those times when foreclosures begin to pile up.

What about REOs (real estate owned)? Will lenders sell the properties they take back from foreclosures for 60 cents or 70 cents on the dollar? Well, anything's possible. But that's certainly not the policy followed by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), Fannie Mae, Freddie Mac, or any of the other big players in the mortgage market. Every one of these organizations tries to sell for a price that comes as close to market value as possible.

In sum, if you try to develop a real estate investment program that depends on bargain prices discounted 30 percent to 40 percent off the current as-is property value, you are setting yourself up for failure. That's why the authors who advocate this approach encourage you to persist against all adversities. Then, if you do fail with their system, it's not the system's fault. It's your own fault. You just gave up too soon.

Why Fix It? To further illustrate this point, let's say that your lottery ticket really does pay off. After fighting the odds, you convince a property owner to sell you a $100,000 house for $65,000. The question then becomes, Why fix it? If, as the examples in Myers's book show, rehabbing fails to yield a positive payback, why bother with rehab? Simply quick flip the property at a price of $80,000 to $90,000. You've still made a fast $20,000 to $30,000 profit and you haven't even lifted a hammer.

Only use renovations to create value.

That's precisely the approach William Bronchik and Robert Dahlstrom urge in their book, *Flipping Properties* (Dearborn, 2001). However, like Myers, Bronchik and Dahlstrom never satisfactorily explain why sellers will leave so much money lying on the table for you to rake into your pile at their expense. Nor do they seriously address the issue of mortgage payoff. Selling for a quick, cash sale doesn't explain such deep discounts. To sell quickly and net substantially more, the distressed sellers could simply hold an auction.

Stretch Your Creativity and Imagination

Kevin Myers, Robert Irwin, and other authors err in their writings about fixers for two reasons: (1) As noted, their fixer profits heavily depend on buying at a bargain price; and (2) correspondingly, they define the term *fixer* too narrowly. To these authors (and most others), a fixer simply denotes a property that's rundown.[2] It needs work. It gives off bad karma. Weeds, odors, out-of-date colors, broken windows, rusty gutters, you name it. The house looks bad. It smells bad. It lacks appeal inside and out.

Many fixers show little or no physical deterioration.

Certainly, such properties may very well hold promise for profitable improvement. But the most frequently recommended fix-up approach fails to adequately tap your imagination, intellect, and creativity. Indeed, the traditional fix-up approach almost encourages you to stifle yourself. "Appeal to the largest possible audience," the authors advise. "Keep everything neutral. Don't offend anyone. Don't venture into the unknown. Sure, you might throw in a few 'gee whiz' features like a skylight or hot tub, but for the most part, just focus on clean and fresh."

Although such an approach can sometimes generate profits, it doesn't require an entrepreneurial vision. It doesn't come close to maximizing profits. This common approach only steers you to rundown houses that you can buy at a steep discount. If no repairs are necessary, no deal. No bargain price, no deal. Consequently, if you adopt this bland, thoughtless approach, you will pass by many properties that could yield great returns.

2. For another author (in addition to yours truly) who knows how to create value—not simply buy at a bargain price—see Suzanne Brangham, *Housewise* (Harper & Row, 1987). Although now out of print, this excellent book can be found in most public libraries or through interlibrary loan.

The Entrepreneurial Approach

In contrast to the traditional view of fixers, here's the entrepreneurial approach:

> As you compare neighborhoods and properties, keep your eye out for ideas you can use to improve the houses and apartments you evaluate. Although most books and articles on real estate investing tell you to buy fixer-uppers, keep in mind that a fixer-upper is *any* home that you can redecorate, redesign, remodel, expand, or romance. The name of the home improvement game is profitable creativity. You can make nearly any home or apartment live better, look better, and feel better. To profit from renovation, the houses you buy need not look like they've been mistreated and neglected for the past 20 years.

Throw away the notion that only run-down houses and apartments fit the definition of a fixer-upper. Sure, poorly maintained properties can offer good potential for value-enhancing improvements. But to keen observers, even meticulously kept properties aren't immune to profitable change. When you stay alert to opportunity, you can always find ways to make a property more desirable to potential buyers or tenants. Consider the experience of Raymond and Annie Brown.

Entrepreneurs can even create value with "perfect" properties.

The Browns Create Value in a Down Market

When Raymond Brown and his wife, Annie B., bought a vacation retreat home they call Woodpecker Haven, Raymond says, "I thought it was a done property. It was only five years old."

Annie B., though, viewed the home from a different perspective. As an interior designer with a forward-looking imagination, Annie B. simply said the home "had great potential." As Raymond tells the story, "Here are some of the improvements my enterprising wife accomplished to transform a livable property into an exquisite home:

- Landscaped the front and rear yards.
- Installed a drip irrigation system.
- Built a stone fence around the pool.
- Added decks around the rear of the house.
- Installed in both bedrooms French doors that led out to the decks.
- Remodeled the guest bedroom and bath to create a master bedroom for visitors.
- Built in a fireplace, bookshelves, cabinets, and track lighting in the living room.
- Trimmed overgrown trees and shrubs to enhance a picture-perfect view from the front porch."

Build wealth in a falling market.

If it can look better, live better, or generate more pizzazz, it's a fixer.

Although Raymond and Annie B. invested $75,000 in these and other improvements, they added around $175,000 in value—throughout a falling market. "We bought our Sonoma retreat," says Raymond, "just as home prices were peaking, and sold several years later, two months before prices bottomed out. . . . Yet we made a $100,000 profit. Our secret? Woodpecker Haven was a fixer-upper we renovated inside and out."

As the experience of the Browns demonstrates, a fixer is any home that could look better, live better, and feel better than it does. (Remember, at the time they bought the property, Woodpecker Haven was only five years old. Recall, too, the Browns made their big gains in a *falling* market.) To fix up a home or apartment building may require you to scrape encrusted bubble gum off floors and counters, patch holes in the roof, fight a gnarled mass of weeds and debris in the backyard, or pull out and replace rusted and obsolete kitchen and bathroom plumbing fixtures. But fixing up a property also can mean visualizing ways to redecorate, redesign, remodel, expand, or bring romance into the property.

In fact, to profit from fix-up work, you don't necessarily have to get your hands dirty. Yes, your sweat equity can pay big dividends, but creativity, imagination, and market research pay much better. So, to create value you can: (1) Look for houses that obviously need work; (2) look for properties whose creative possibilities would be overlooked by most buyers; or (3) look for properties where you can improve both the physical condition as well as the overall appeal and livability. The better you can envision opportunities that other potential buyers fail to recognize, the greater your potential for profits.

My Awakening

Like the great majority of property owners, at one time I followed the traditional fix-it approach to buying and improving my rental properties. Then, when I was enrolled in my doctoral program at the University of Illinois, I chanced upon a talk about real estate with one of my professors. He told me that since building a new home he had unsuccessfully been trying to sell his previous house. After a year on the market, the house remained unsold. He asked me if I would be interested in buying it. I agreed to take a look.

Great House, No Appeal The house was located in a desirable neighborhood only a short bike ride from the U of I campus. As to physical condition, the house showed virtually no disrepair. No buyer would have called this house a fixer. Yet, when I thought about making the property my home, I was not enthused. The house lacked warmth and cheer. It was too dark inside. The color schemes made army olive look bright. Heavy

Earn a 5:1 payback for creative cosmetic improvements.

custom-made drapes (of which the professor was especially proud) in the living room and bedrooms also added to the home's dreariness.

"Thanks, but no thanks," formed my initial reaction. But fortunately, a more creative friend who visited the house with me immediately began to visualize the changes that she would make to the home if she were to live there. With just some relatively minor changes, she thought that she could transform the property's look, feel, and livability. She proved to be right.

I did buy the property, made the changes, and subsequently sold the house at a price significantly higher than my professor had been asking. My payback on out-of-pocket renovation expenses was about five to one.

A Home, Not a House From that moment on I dramatically changed my perspective on fixers. I realized that to most profitably improve a house (or apartment unit), you must first think of it as a home. Then you must abandon the mere fix-up mentality in favor of transformation. Don't merely dress the property up in a new outfit. You must think of your work as a Sally Jesse Raphael makeover, or perhaps as Henry Higgins thought of his Cockney drudge in the movie *My Fair Lady.*

Create a *My Fair Lady* makeover.

Unlimited Potential

As you apply the entrepreneurial perspective, you will recognize that profitable properties may come in all sizes, shapes, and types. Rather than merely judging a property for its fix-up potential, you will inspect it for a much more extensive range of improvements. Likewise for the neighborhood.

Most importantly, you will evaluate your potential improvements through the lens of market strategy. You will persistently try to create that combination of features and amenities for which targeted buyers (or tenants) will gladly pay a premium. Through market research you will discover the most profitable ways to favorably differentiate your properties from those of your competitors (other sellers or owners of for sale and for rent properties). Throughout this book you will learn to ask and answer many detailed questions that will help you exploit opportunities that the majority of investors and homebuyers frequently miss. For example:

You can even improve "perfect condition" properties in a dozen or more ways.

1. *Livability.* How can you improve the floor plan, traffic patterns, resident privacy, egress, and ingress?
2. *Living space.* Can you add living space through a room addition or conversion (garage, porch, basement, attic)?
3. *Storage.* Where are the dead spaces that could be enhanced for storage? What ideas can you borrow from the California Closet Company to add storage capacity without necessarily adding new storage space?
4. *Income potential.* How might you create auxiliary independent living space such as an in-law suite or accessory apartment? Can you create private living space for a teenager or live-in help?
5. *Roommate living.* If you plan to hold (or sell) the property as a rental, how might you modify the space or living areas to more pleasantly accommodate roommates or other types of shared living arrangements?
6. *Rightsizing.* Are some rooms or areas too large or too small? Does the room count and functions (bedrooms, bathrooms, great room) best match the needs and wants of your most profitable target market? What changes are possible?

7. *Operating and maintenance costs.* Can you switch from high-maintenance materials to low- or no-maintenance items? What can you do to reduce the utility bills?
8. *Capital costs.* What steps can you take to minimize the costs of property taxes, property insurance, assessments, or mortgage interest for your buyers (or yourself)?
9. *Aesthetics.* How can you romance the property, add pizzazz, or enhance a bright, cheery, or warm feeling?
10. *Views.* Can you enhance or create a drop-dead view? (No, you don't need mountains or lakes. A flower garden or ivy-covered trellis might also provide a pleasing respite.) Can you eliminate any ugly or distasteful view? Can you add or subtract windows?
11. *Landscaping, trees, shrubs.* What can you add? What should be cut away? Can you improve the yard's appearance with fertilizer, mulch, walkways, fountains, fish ponds, or fencing? Would a different type of grass grow better or look better?
12. *Security.* In our crime-conscious world, what can you do to diminish the home's susceptibility to break-ins?
13. *Safety.* Can you enhance the safety of the home for children, seniors, or just plain everyday living?
14. *Special-purpose use.* Can the property (or any part thereof) be profitably adapted for use as an office, artist's studio, or rentable storage area? Can you profitably adapt the property to better serve the needs of the disabled?
15. *Site.* Can you rightsize the site by acquiring part or all of a contiguous property or by subdividing or splitting off part of the existing lot? Does the size of the site allow for additional building, storage, or parking?
16. *Neighborhood.* What can you and neighborhood property owners do to upgrade or revitalize the community or neighborhood? Contrary to popular perception, you can change the location of a property. You can change the location when you improve the schools, redirect flow-through traffic, beautify properties, or reduce crime.

17. *Neighbors.* Sometimes a disrespectful or callous neighbor can create value-diminishing problems for nearby property owners. What can you and other property owners do to bring that wayward neighbor into line?
18. *Legal.* What laws and regulations (zoning, building codes, homeowners association rules, easements, deed restrictions, environmental standards, health and safety ordinances) control what you can and cannot do with your property? By learning the detailed ins and outs of these dos and don'ts, you can avoid costly blunders and capitalize on seldom-noticed (or recently emerging) opportunities.

By securing a change in zoning, a variance, or a special-use exception, you can dramatically add value to a property. You can also use zoning codes and ordinances to discipline those scalawag property owners (tenants) whose behavior adversely affects neighborhood property values.

As you can see from this list of 18 possibilities, entrepreneurs create value for their properties by systematically examining the house, garage, outbuildings, site, neighborhood, neighbors, and all critical laws, rules, and restrictions that regulate property use and design. In contrast, most buyers (and sellers) remain uninformed about many of these potential areas for profitable change. They typically inspect only for needed repairs and superficial cosmetic improvements. As a result, they miss some of their best opportunities to enhance their returns.

Profit from the ignorance and oversight of others.

Fortunately, such ignorance and oversight will work to your advantage in two ways: First, you may face less competition for good properties. Second, due to the fact that sellers often fail to recognize the true potential of their properties, you can buy great properties for much less than they are really worth. In this sense, I don't mean far less than a property's current as-is market value but rather a market value price that still yields wide room for a large margin of profit.

It's true that you can occasionally find steeply discounted prices offered by those so-called motivated sellers that most real estate authors write about. But your success as an entrepreneurial fixer should not rely on that relatively rare occurrence. By thinking entrepreneurially, you will dramatically expand your profit opportunities.

Multiple Ways to Profit

As you master the art of creating value, you will pleasantly discover that you can earn your gains and build your wealth in multiple ways.

Fix and Quick Flip

Using the fix and flip approach, you buy, renovate, and sell a property all within the shortest period possible. This technique works well to generate fast cash. You can then pyramid these profits to reinvest in larger and higher-profit projects. Suzanne Brangham (the author of *Housewise*) began her fix and quick flip career with an unseemly $40,000 condominium (that she sold six months later for $80,000). Then, over a period of years, Suzanne worked herself through dozens of properties all the way up to multimillion-dollar executive homes.

Quickly build up your cash through fix and flip.

However, under current tax law, multiple quick flips may expose you to onerous personal income tax liabilities. You will need to consult tax counsel to either work these transactions within a corporate structure or a tax-deferred retirement account such as an IRA