

# THE NUTS AND BOLTS OF “FIX AND FLIPS”

A short course by David Ball

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## Getting Started

Before we can start down to road to successful “fix and flipping”, we need first to define our terms. What is a “fix and flip?” How does it differ from other investment purchases, and what are the implications of those differences?

For the purpose of this paper, we will define “fix and flip” as the purchase and restoration of a non-owner occupied residential property for the purpose of reselling that property in the “near term” to an uninterested third party for a profit. Inherent in this definition are several salient points, to wit:

- a. This is different than “rental property”, whether or not that property requires restoration.
- b. This is, by definition, a “short-term” venture, “short-term” defined as the whole “fix and flip” activity taking place in under one year’s time.
- c. This is a business exercise, as opposed to the updating or restoration of one’s own home.

There are at least four reasons why these differences are important to this discussion; first, I have no expertise in “a” and “c” above; secondly, this is the standard definition of “fix and flip”, and so if you are looking for wisdom on owning rental property, you are in the wrong place; thirdly, much of the advice in this paper will concentrate on the “business” of “fix and flipping”, and as such, will not benefit someone wishing to work on their own property; and , finally, and most importantly, there are serious financial and legal differences between the above-defined “fix and flip” project and other projects involving distressed properties.

Having said that, the practical advice herein might provide some insight or help to the homeowner, or a owner of income (rental) property seeking to improve his/her handyman skills, but, practically speaking, this is an introduction to the art and business of true “fixing and flipping”.

Now that we have defined our terms, let’s look a bit into the financial and legal reasons that it is important to do so.

1. Generally speaking, the tax implications for “fixing and flipping” are quite different than those for rental properties. The primary difference is that profits (should there be any!) of a fix and flip project are considered “ordinary income”, as opposed to “capital gains”, and, depending on your tax status, that difference could be quite astonishing come tax time.
2. Secondly, your ability to secure insurance for “fix and flip” houses will be more challenging (and often more expensive) than insuring a long-term income property.

3. Third, the wonderful gift called IRS 1031 exchanges will not be available to you as a “fix and flipper”. That device is limited to longer-term investments.
4. Finally, and maybe most importantly, financing of “fix and flip” properties can be quite different than financing any other kind of real estate, and often quite more expensive.

If these points haven't scared you away yet, note that, despite the efforts of lenders, the FHA, the VA, insurers, and the IRS, there is good money to be made in the wonderful world of “fixing and flipping”. So, if you are still reading, let's talk about

### **David's Top Ten Flipper Maxims:**

#### **1. First Things First—Consult the Pros**

It has oft been said that anyone who would consider doing “fix and flips” needs professional help—and I couldn't agree more. At minimum, you need, before you look at your first property:

- A. An Attorney
- B. An Accountant
- C. A Realtor
- D. An Insurance Agent
- E. A Lender

Let's talk about them in turn.

Depending on how seriously you are thinking about entering this field, you need legal advice. I would suggest that if you are intent on doing more than one “fix and flip”, you should definitely begin with a business attorney, although it is probably a good up-front investment regardless of how deep into this you plan to get. If you plan to hire people other than your immediate family, you definitely need to consult an attorney. There are two main reasons; liability and taxes. As for liability, this can be dangerous work, both to you and, potentially, to others. Although there are other legal considerations, the primary one is whether or not you should incorporate your new venture. A good attorney can advise you on the costs versus the benefits of whether or not to incorporate and, if so, which of the various forms of incorporation (or limited liability formats) are the best for your situation. Not being an attorney, I will leave it at that, but I will say that, for the money (which will be less than you might imagine), this is a critical first step that should not be side-stepped.

Accountant. Since the world of fix and flips is a “short-term”, or “ordinary income” world as far as the IRS (and, as a result, most State Tax Authorities) is concerned, not only talking to, but retaining, a good corporate accountant, is of absolute importance if you enter this business on any other than a casual basis.

My accountant routinely saves me more money each year than I spend on her services. I have done my own taxes all of my life, but when I entered this field (and incorporated), I realized that I had entered a land where my talents were best spent fixing up old houses, not misinterpreting the IRS tax code. As an example of how my attorney and accountant work together, since I am incorporated, I can pay myself and my wife (and sometimes my children) as employees and deduct our salaries from the business's income. Further, we contribute profits to Simple IRS funds, which defers the taxability of our venture into future (retirement) years, when our tax rates will be lower. One drawback to this setup is that you will have to deduct employment taxes from your salaries and start making quarterly 941 and related State reports, but in the long run, the benefits gained from this sort of arrangement could be much greater than the cost of these inconveniences.

Realtor. If you are a Realtor, consult your employing broker before you start buying and selling your own property. Make sure you both understand the terms of your mutual relationship. There are "in-house" agreements on buying and selling your own properties that range from a full commission to a small "coverage" fee for an agent as dealer. Make sure that you know how your company handles these transactions; the dollars involved are substantial.

If you are not a Realtor, and you plan to do more than one "fix and flip" per year, consider sending yourself, your spouse or child to Real Estate School. As a Realtor, you will get paid 3% of the sales price (depending on the market) when you buy your project, and will pay out 3% when you sell. If you are not a realtor, you will pay nothing buying the property and 6% when you sell. That's a 6% difference out of your pre-tax income. On a property worth \$150,000, that's \$9,000 profit down the drain. Compare that to a \$2,000 investment in a Real Estate license, and it doesn't take a rocket scientist to figure out why most of the successful "fix and flippers" are licensed agents.

Until you are licensed, you will need a good Realtor. My preference is for a large company, with a lot of agents and a corporate environment where agents cooperate with each other rather than stab each other in the back. Make sure that you find an agent with many years of experience, and be doubly sure that much of that experience has been in the purchase and sale of distressed properties, or at least in working with clients who are investors. There are usually a few agents in any sizable company who specialize in these skills. The trick is in trying to find them, as other agents, who will want your business might either claim experience they haven't really had, or shield you from those who have. There are two ways around this; first, spend time on the home page of the company you are interested in; read the bios of the agents. Secondly, if that produces nothing, interview the managing broker of the office, and explain what kind of agent you are looking for. If that doesn't produce, there are always other firms to work with!

Insurance Agent. Insurance is a fact of life, and woe to the fix and flipper who forgets or foregoes insurance. You will need two types of insurance, depending on your legal situation. First, there is general business liability insurance, and it's not cheap. This will protect you from injuries, accidents and law suits from others on account of your business activities. Most good business agents sell this insurance. Secondly and most importantly, if you plan to do more than one fix and flip, is hazard insurance, that policy that you have on your own house to protect against fire, vandalism, etc. If you plan to have employees on the payroll (other than family), you might get involved in Worker's Compensation Insurance as well. Although I have no first hand experience with this, I am aware that it is very expensive, complicated, and that you should make sure you are working with an agent knowledgeable in this type of coverage.

I always buy a high-deductible, six-month hazard policy, since it's only there to protect against catastrophic loss. It's cheaper, for instance, to replace \$500 of "missing" tools once in awhile than to buy the "soup to nuts" coverage. In general, the rule that insurance is there to protect against major loss (be it home, health or any other kind of insurance), rather than to insure against any liability, has always stood me in good stead.

For some reason, business liability policies are pretty predictably priced, but hazard insurance policies on "fix and flip" policies can vary immensely. I have, for instance, been quoted hazard insurance on a \$100,000 home at levels between \$400 and \$2,000 per year! Most of this comes from the fact that most insurance companies hate to insure unoccupied properties, for obvious reasons. After quite a bit of searching, I found a company (a large, national company at that) that would insure my "fix and flips" at a very reasonable rate if I would bring my home insurance to them. To me, this seemed like a fair deal; it helped the agent establish credibility with his underwriter, and let him know that I was willing to be a true partner. We have insured over 20 homes together now, and I get rates that nobody else that I know doing this sort of work gets anywhere else.

Lenders. Let's talk about lenders in general here, and defer types of loan instruments and their pros and cons in a future section. Just as in the above professionals, your lender will serve you best if; a. He/she is familiar with your particular line of work, b. has been in the business for a long time, c. works for a local, well-established business, and d. has time to learn about your needs. This will not necessarily be you present banker. At minimum, you should seek out an institution that does business financing as a matter of course, can handle a wide variety of financial needs (checking, savings, investments, lines of credit and mortgages), and has several bankers/lenders on staff. This last point can be very important, because there is quite a bit of turnover in banking/lending, and secondly, because the first lender you work with might not be a good fit for you. If you have all of your accounts with the bank and you are teamed up with someone who doesn't mesh, and they're the only business banker in the

company, you're, so to speak, screwed. The financial part of this business is just too important to find yourself in that position

Which brings me to a final point—loyalty. These professionals are all just as important to you as you are to them. I have discovered, working with the same people year after year, that when problems arise, or I have unique requests, they are there for me. The same extends to my carpet company, my electrician and my banker (more on this later). They know that I am in it for the long term, and that all I expect is a fair price and good service. They in return can know that although I occasionally check to keep them in line, they can expect my repeat business, patience when they're busy, and quick payment. Shop around to establish a fair price, but over the long term, you will find more value in a truly professional relationship than you ever will in always getting the lowest price.

## **2. Size Matters**

Basically, there are two different models of the “fix and flip” business; the first is to buy on the low end, do a quick fix to ensure safety, attractiveness and marketability, and sell off the house as quickly as possible. The second format is to buy a specialty high-end property and spend quite a bit of time making it unique and special. My experience is that it is very difficult to do both, and that anyone in this business to make money should most likely decide on one or the other model from the beginning and stick to his or her guns. There are several reasons for this. Certainly, there is the financial reason, and an in-depth discussion of this is pre-mature at this time, not having yet discussed financial models. Suffice it to say that in order to buy high, you need either a lot of cash or a lot of equity. The second reason has to do with timing; a high-end property will be yours for much longer than one on the low end. There will be considerably more holding costs, utility bills, insurance fees, etc.

But, the main consideration here is certainly one of style. Style, you ask? Yes, indeed. Who you are and what your values are, and how you work and what sorts of work you prefer are, believe it or not, really the most important determinants in choosing between these two business models. Are you a “detail person”, or someone who wants to just “get it done” and move on to the next task? Is pretty good, good enough, or is the major value in your handiwork perfection? A high end property, bought well, can return a wonderful profit; but it will also require the expenditure of much more money, more time, more reliance on outside contractors, and, usually, a longer selling window. It will also command a higher level of workmanship, more costly materials, and some very particular talents.

My experience has been in the lower end. I routinely buy and sell between three and five properties per year in this sector of the market. I find that my personality and talents are suited to this type of “crank it out” sort of work, and thus, I'm

happier and more fulfilled working in this price range. My goals here are for a house that is clean, safe, up to code and affordable. In addition to having a variety of projects to work on over a year's time, I enjoy the feeling that I am providing safe, reliable and affordable housing to many first time home-buyers, many of whom are single mothers finally getting out of the rental cycle.

But, if I were of a personality that craved detail work, took an almost artistic interest in the field, and had a bigger bankroll, perhaps I'd find an equal level of accomplishment in flipping one, or perhaps two, old Victorians or custom builds every year. It doesn't so much matter which direction you head, but it does seem to me that it makes more sense to fit your personality and values to your work than to merely attack any project that presents itself. With the advent of recent TV shows extolling the virtues and romance of fixing up larger, older and more interesting homes, it would be easy to fall into the trap of thinking that those homes are where the market is, or where you should spend you time, effort and funds. Take some time to take inventory of your skill set, your patience, your working capital and your values before assuming that all of the money, the fun, and the action is necessarily in the high end of the market.

One final comment on the "business model"—Regardless of which road you head down, try to remember this one crucial point; **THIS IS NOT YOUR HOUSE!** How often I have seen investors attack a project as if they were renovating their own home, or, worse yet, their "dream house". The object of "fixing and flipping" is to make money, not to build a castle for yourself. Marble countertops and high-end windows don't make sense in a less expensive house, despite the fact that you personally might think they look wonderful, or that you happen to have a special talent for installing marble countertops, etc. I can think of no error more common and more costly than overbuilding the neighborhood. Sure, you might get a quicker sale with some fancy upgrades, but spending the time and money you would spend on your own home on a fixer project is a sure road to failure. Later on we will discuss exactly what sorts of upgrades make sense in what sorts of price ranges, but suffice it to say that if you don't see the sort of thing you are contemplating in other properties in your target neighborhood, it's probably for a good reason (P.S. Make sure your Realtor shows you other homes in your target neighborhood as part of the pre-purchasing pricing exercise—more on this later, too).

Here's another question to ponder that might help you understand what sort of business plan to pursue: "Are you a restorer or a renovator"? If you don't see a difference, get a dictionary. When I started business, I intentionally called my company Phoenix Restorations, Inc., because, thinking it through beforehand, I realized that there is a substantial difference between the two words, and between the two businesses that are true to them. To "renovate" means "to make new again" whereas to "restore" means to "return to a prior level or condition". I am not in the business of making silk purses out of my sow's ears. I'm in the business of returning them to an approximation of some prior,

acceptable and livable condition. If your heart is pining to do the things you have been seeing on some of the Home Improvement shows, that's great, but be sure going in that doing that sort of work is a good fit for your resources, both financial and vocational.

### **3. Know Thyself**

We've just spent some time on trying to fit your skills, or, lacking skills, your interests, to your business plan. I cannot say enough about how important this is. And it's important on two levels; the first, to which we alluded above, is to match your personality and your skill set to the sector of the market where you want to buy and sell; the macro level. The second reason that it is important is the micro level; the level where you decide which particular house to buy in the first place. In a smaller market, you might not have a choice of, say 5-10 target purchases, but for those lucky enough to be working in a city or other larger residential market, you might find yourself in a situation where you can choose between several viable projects. If so, what are the criteria you should use to "pick a winner"? Certainly, there are the financial exercises that we will explore later, but for the time being, try this on for size. All other things being equal, you should buy a home that needs work that you, yourself can do! DUH! You'd be surprised at how many would-be "fix and flippers" miss this seemingly obvious maxim!

Just as there are two sectors of the market to pursue, there are two substantially different kinds of people doing this kind of work. The first I will call "the contractor"; someone who primarily is in the business of identifying, buying, arranging for the repair of, and selling a distressed home. They make their money in their purchasing expertise, their real estate savvy, and in sheer volume. But they don't really get their hands dirty.

The second type of "fix and flipper" is the person who actually does much of the rehabilitation work his or herself. When I first entered this business, I thought that basically everyone in the flipping racket was this later type of handyman/fixer. Not too long into the job, I began to realize that this type is actually in the minority. Many people claiming to be "fix and flippers" would, in a conversation with me, say, unbelievably, "You mean you actually do the work yourself?" It was quite a shock to me to find that they actually didn't!

So, there seemingly is room for both approaches in this business; but for my money, there is nothing like taking on a project and seeing it all the way through to the sale, warts and all. It's really where the big money is, as well. Certainly, I cannot fault the Realtor who, once or twice a year, finds a bargain, hires out some work, and clears a relatively uncomplicated \$5,000-\$10,000. But this is primarily a treatise on the WHOLE job, soup to nuts, and I can't imagine doing it any other way, for the fun (and much of the profit), is in the physical work.

It goes without saying that every dollar you spend on outside help is a dollar you will not pocket. But, it's worse than that. Professionals routinely bill out at \$60-100 per hour. Until you are consistently earning that kind of income doing something else, why would you hire outsiders to take your place? For sure, you will need to hire in people who do specialized work that you don't know how to do, or, for legal reasons, cannot do yourself (I, for instance, because of local building codes, have to outsource major electrical work and roofs). But, try to keep the majority of work for yourself. Besides the financial aspect, there are other reasons that this makes sense; 1. You learn new skills and become more efficient the more you do on your own; 2. The sense of accomplishment and inner peace that comes from doing your own physical work cannot be denied—you will grow in many ways. 3. Finally, when you work on your own, you control your schedule and the work flow; when you hire out, you are at the mercy of other people's schedules and values. (Contractors' respect for their clients' time are the things of legend)>

So, back to the main point, which is (especially in the beginning), try to find initial projects that match your skill set. Are you a good painter? Not too bad at sheetrock/framing? A whiz at tile and carpet? Great. Then don't buy a house that needs plumbing upgrades and new windows! My experience is that I have tried to find projects that give me the opportunity to learn one or two major new skills while mostly offering opportunities to ply the skill I already possess. After your first 10 projects or so, you'll pretty much be to the point where you can do pretty much anything. But until then, take in on progressively, building your expertise one or two new skills at a time.

Which brings us to the final point of "know thyself"—what do you have the stomach for? Let's face it—there are all sorts of people in the world. And some people have a high tolerance for certain things that others would never tolerate. These houses are typically not sold because they've been loved to death. Their condition, to be delicate, can run anywhere from "needs cosmetic work" (uncut lawn, ruined carpet, holes in the walls) to "a project for the real handyman" (no lawn, dog feces on the carpet, bullet holes in the walls) and WORSE! In previewing perhaps a thousand houses on my way to buying 30, I've seen it all. And, I've bought it all, which brings me to a little story: A farmer's grandson from the city is visiting him for a week in the summer, and they go out to the pig pen. The little kid catches wind of the pig manure and asks granddad "What is that terrible smell, grandpa?". His grandfather turns to him and says "Son, that is the smell of money!"

The worse shape something is in, the more money there is to be made. But that doesn't necessarily mean you should corner the market where every project requires that the first tools used are a shovel and a match. Not everyone is comfortable around the sort of odors, stains and particulates that the "salt of the earth" can produce in their less fortunate moments, especially if your family is

involved. My experience is that with a lot of sweat, a good mask, and 20 gallons of “Kilz”, any horror show can be turned sane in a couple of days. Nonetheless, just because this is true doesn’t mean that it’s where your joy lies. Know yourself before you venture into the weirdest of the weird. But, if you can take the heat, there’s gold in them thar dumps.

Finally, a bit of an economics lesson. There is a tenet in economics called “opportunity cost”. Basically, it refers to the cost of that which is foregone to pursue something else. For instance, you decide to play golf for an afternoon. The cost of the golf outing might be \$50 or so, and the reward is probably pretty high, depending on your experience and the number of beers consumed. Nonetheless, in order to play golf, you have had to forego working on your latest project, during which, in those 6 hours, you could have improved the property \$200 worth. This \$200 is your “opportunity cost” of playing golf. This concept permeates your life, whether or not you know it. And, like anything else you spend your time on, it relates to your “fix and flip” world. “Time is money”, the old adage goes. And, at the heart of that old saw is this concept of opportunity cost.

How does it relate to you? Let me answer by illustration. When I began fixing up properties, I kept track of not only the cost of my materials, tools, insurance, utilities, etc., but I also kept a detailed log of my time. After my first few projects, I had a pretty good idea of how much I was making “by the hour”; in my case, about \$100. As I wasn’t a full-time fix and flipper, I constantly had to evaluate whether the other things I did to produce income were at least worth my \$100; if not, then, all other things aside, it made pretty good sense to forego them in favor of more fix and flipping. You can see, inversely, why some pretty high-powered Realtors think me crazy for “doing the work myself”. They’re probably making much more than \$100 per hour in the aggregate, and it therefore makes more sense for them to use their time generating high-priced real estate commissions to fuel their fixer projects, but not to take time off of their Real Estate work to beat themselves up (assuming they have the skills in the first place) demolishing a dump.

This sort of usage of time analysis is something you should be running in your head all of the time, in all phases of your productive life. But, of course, there are other considerations than merely how much income something is producing that go into the overall question of how you divide up your daily 24 hours. For me, I find peace and creativity transforming a pig’s eye of a house into a silk purse of a home; I find great satisfaction in providing, at a fair return, safe, affordable housing. And, the solitude I crave is found with hammer and saw in the bowels of the latest distressed property investment. None of these considerations make any sense economically, by psychologically, there worth more than money.

So, enough philosophy, but before we leave the world of micro-economics, let me suggest one more of many applications of the opportunity cost concept. At some point, if you are young and are having success in the fixer world, you will

want to run an analysis about whether you are better off continuing your one-at-a-time project business, or whether you should consider doing two, perhaps three or more projects at a time. Certainly, such a move will push you headlong into the area of “contracting”, employing others with all the concomitant hassles of that (insurance, payroll, withholding, FICA, supervision, etc), but it could also build you quite a little empire. Using the tools we have been discussing (while at the same time re-visiting your attorney and accountant) should help you figure out when/if such a move is viable. But, since this chapter is entitled “know thyself”, let’s not forget that the bottom line is just one of many considerations in a balanced, fulfilled life.

#### **4. To Thine Own Self Be True**

This chapter is a companion piece to the preceding one. It also deals with getting to the bottom of your motivation, in the hopes of allowing you to enter this business with a clear understanding of the personal risks and rewards. For me, the first major decision I had to make when I first considered acquiring “income property” was whether or not to “flip” or “hold”; whether or not I wanted short term or long term ownership. Most of my Real Estate colleagues can’t understand why I chose the former; they, invariably, are owners of rental properties and they have built, over the years, impressive portfolios. Certainly, the tax codes are with them, and there is, perhaps, less risk in a longer term investment, but for me none of that really mattered. I merely had a massive aversion to being a “landlord”. I had heard the stories; in fact, I had, of necessity, been a long-distance landlord once or twice in my earlier years, and I knew, in the core of my soul, that I didn’t want that type of stress in my life.

Which brings us to the core of this section. For me, life is just too damned short to spend it doing something I don’t want to do. It is perhaps a perversity that I love shoveling shit out of someone’s nightmare house, seeing the potential in the ashes, but there it is. You, as well, should do some serious soul searching about your values, your aspirations, your goals and “what makes you tick” before investing serious money in your first project.

Major first questions should be: 1. Do you want to be a landlord, 2. Do you want to do your own work or hire out? 3. Do you want to work alone on one project at a time, or do you aspire to overseeing a larger concern, with the associated risks and rewards. Those three at least should be given serious consideration before you embark on your first voyage. Some serious soul-searching up front could save you, and those who love you, major damage.

OK. So, you’ve asked the hard questions, consulted the pros, and are now ready to forge ahead. One final suggestion is in order. Separate business from emotion! Remember that you are basically in business to make a profit, and that although there are personal issues surrounding your approach to how you do this

work, the bottom line is that when push comes to shove, you're probably in this for the bucks.

One of the biggest mistakes I've seen people make in this business is becoming emotionally involved in their investments, either when initially buying a property or during the fixing up phase. Fantasy is a wonderful device; it allows us to elevate ourselves from our normal experience and play in a different world; something we all can use from time to time. But, in the business of buying and selling assets as large as houses, it has no place. Getting caught up in the indulgence of projecting your personal fantasies onto an investment property is just bad business. Later on we'll explore "running the numbers"; evaluating a potential investment. For the time being, however, suffice it to say that if there is any one thing that should be remembered by the "fix and flipper", it is **THIS IS NOT YOUR HOME**!

## **5. Do It By The Numbers**

It's so relatively easy to evaluate a potential property purchase by the numbers that it constantly amazes me how few people do it right, or for that matter, do it at all. It's really a straightforward process; run the comps, figure out the materials cost, calculate the selling and holding costs, estimate your "minimum acceptable return" (profit), and, presto, you've got your minimum acceptable purchase price. (See Addendum C). The whole point is to determine at what price a potential subject is "acceptable", not to establish the "best" price, or the "market price". By determining up front how much you are willing to pay in order to make an acceptable profit, you know when to bail and move on; and you are more or less assured that, if you can work out the deal, you will receive a pre-determined "profit" on your project. It's important that you understand why "profit" is in parenthesis; since this isn't in a real sense a true profit. This number is a value of what your time spent on the project is worth. In other words, it's the amount of cash returned to you after all the bills are paid with no consideration for the time you spend on the project. It is both your return for your time and your return on your investment; thus, it should be a considerable amount of money as a percentage of the purchase price; perhaps 20% or so. It will be tempered by two things; the current market and, most importantly, the amount of time you will need to spend on the project.

While we're on the subject of the "current market", let's take a few minutes to talk about timing; that attribute that has made or broken many a comedian and flipper. I have bought and sold property in all sorts of markets, and can report that although every type of market has its challenges, there is no particularly good or bad market condition for doing fix and flips. It stands to reason that in a "down" or "slow" market it will be harder for you to sell your property when it is done. As a result, I have heard many an investor say of such markets that they are harder for this work and, in many cases, should be avoided, or waited out. To me this is bad advice for two reasons; 1. It limits your ability to make money

by reducing your productive time, and 2. It doesn't understand the true nature of any economic market and the law of supply and demand.

In a slow market, there is usually an overabundance of listings and a limited number of buyers. Common economic theory would dictate that in such a situation, prices would be falling, and that a buyer could pick up a bargain or two. On the selling side, it will indeed be harder, once done, to sell your rehabbed property. But, there are two things in your favor; first, you have a beautifully reworked property for sale (as compared to much of your competing listings), and, secondly, you bought this property at a steal, so you have a greater ability so price it below the (unrealistically optimistic) competition, and you have enough cushion in your calculations to realize that you will most likely need 6-9 months of carrying costs rather than the 3-6 you'd find in a stronger market. As long as you understand the market you are operating in, and run the numbers accordingly, it shouldn't matter. The profit should be there!

Conversely, in a strong (seller's) market, you will most likely have a limited number of properties to buy and you will most likely be buying for a premium, but, when selling time comes, you should be able to sell quickly (minimizing your holding costs) and sell at a strong price. Regardless of the market, the spread between buying price and selling price should be more or less the same. The trick is to understand the implications of the market you are in when you do your initial calculations; not when it's listing time!

One final comment on market conditions: market dislocations. This is where some real money can be made. A market dislocation can be defined as a temporary disequilibrium between stable markets. For instance, the community where I live happen to host several military bases. There are times of the year when troops are commonly re-assigned and PCS (permanent change of station) into and out of our community. Aligning purchase and sales dates with these fluctuations can create a favorable increase in the typical profit to be made. Likewise, in most places Real Estate is highly seasonal. If you only do one or two projects per year, it makes sense to buy in the late Fall or Winter and sell in the late Spring or summer. This is not so say that other times of the year can't produce a good profit, but it does speak to that fact that there are times when supply and demand are in flux, and that taking advantage of these dislocations can add an extra layer to your profit picture. Get to really know your local market, it's timings and its eccentricities. Read the business paper regularly (if you have one). Are layoffs coming? A new large employer slated to move into town? The foreclosure rate moving up? Interest rates moving down? All of these transitory conditions are market dislocations which could provide an extra margin of profit for the savvy investor.

A. Comps. Any good Realtor (or for that matter, any bad Realtor) can provide you with comparable properties for the one you are considering buying. "Comps" are the most effective and easily available way to get a quick feel for the "fixed up" price you could command as a seller once your project is done. But "comps"

can be seductive and falsely alluring—they can also be just plain wrong. At minimum, good comps should be no more than a year old in a stable market and 6 months old in an unstable market. They should only be recently sold properties; never listed or pending properties. They should be located within a mile of your potential purchase, and (for me, most importantly) should be within 10% of the total square footage of the property you are considering. Many Realtors I know add to this list a pre-supposed price range, which to me stacks the deck in favor of their own supposed knowledge of the market. Nothing is to be gained by doing this, and plenty can be lost. As well, remember that you are comparing a distressed property against recently sold (and mostly very presentable) properties, and so the prices of your “comps” will be well above the price of your property (unless you are lucky enough to find “comps” which are also recently sold dumps; pretty unlikely). The whole purpose of this exercise is to establish a base line selling price of your project AFTER you have added the value; thus, it should be considerably under the prices of all of the comps you can find. Pre-assuming comp prices confuses this exercise and often creates a false impression of the true market. Tell your Realtor not to put a “price” criterion in their search when they are looking for comps.

One problem with this, as important as it is, is that, occasionally, your comps will contain either too wide a spread of prices, or two tiers of pricing. Sometimes, a newer subdivision will fall within the boundaries of your search (assuming you are searching on the lower end—it can work in reverse if you are trying to comp fairly expensive properties), and you will find those newer properties skewing prices to the high end. One solution is to put a filter concerning age of house, or any other sensible criterion that will exclude the aberrant properties.

In the final analysis, comps are only as good as the judgment that goes into them. You need to study them to uncover the message they are trying to relate. Read the comments, note the style and age of the house; really get into the data that are available there. This first step is so important that it is really in your best interest to analyze the comps to make sure you get it right from the get-go.

Once we have established at least five good “comps” (I know this will be hard in a rural market, but on the other hand it will be hard for your buyers too, so there will just be more uncertainty in each project, which should even out over time, and which, as you get to be the local expert on this type of property, should work to your advantage), you now have a good feel for your “total income” figure. From this, as with any other income statement, all we need to do now is subtract our expected expenses to derive the price we would be willing to initially buy the property for.

**B. Material Costs.** This is probably the area where the highest degree of certainty can be known in the beginning. Conceivably, if you can make a list of what materials you will need, you should be able to trek down to Home Depot or Lowes and total it all up. Of course, it’s not all that easy, but it’s really not too far

off from that either. I'd recommend adding 5-10% on top of your estimate for unknowns and incidentals, but anyone fairly familiar with construction (and if you're not, get some help on this, especially in the beginning by hiring a property inspector and a contractor friend to help fill in the blanks) should be willing to come pretty close.

Realtors and other "hands off" investors consistently overestimate material costs. Don't rely on them for these numbers. First of all, they're used to spending other people's money by hiring contractors, handymen, property managers, and a variety of other (costly) experts on behalf of their clients, and, as a result, have no real idea of what the true costs of such things are for someone like you, who is doing his/her own work. Secondly, they have absolutely no expertise in distressed properties (unless you are lucky enough to find a rarity), and thus aren't even speaking the language you speak.

My experience is that it is rare that materials costs (even including those you hire out) will never amount to more than 10% of the final, finished sales price of any property. If they do, you might not have enough room in your project to make all of the other numbers work, or you are just planning to contract out too much of the work. One other possibility is that you have violated our cardinal rule: "This is not your house", and are planning to overbuild the market. Shame on you!

C. Selling and holding costs. Once again, these costs are really quite simple to approximate, although, surprisingly, they are often overlooked. Certainly, if you are not licensed as a Realtor, you will have to consider paying 6-7% commission on the selling of the property, unless you go the "for sale by owner" route, which is another book in itself. Prior to entering Real Estate, I sold a couple of my own properties; one with great success and another which was a total nightmare. It's you call, and 6% additional profit is hard to forego. Just remember what a highly respected real estate attorney told us at a training session once; "90% of all Real Estate law suits are "for sale by owner" issues."

OK, so whether you sell or not, you should be able to make a pretty good stab at selling costs. You will need to add to these initial expenses such things as discounts off of the list price, concessions to the buyer, your closing costs, home warranty, should you provide one, and "carrying costs", those costs associated with borrowing money during the time you own the property. In a down market, these can be excessive and eat you alive so, as we have discussed earlier, try to be brutally honest about carrying costs going in, and it will allow you to make more strategic decisions on the back side.

A note about "seller concessions" to the buyer. I strongly recommend that you develop a mind-set that assumes these from the beginning. Especially if you are working the lower end, or, if you are in a buyer's market, you will need to "give something away" when you are lucky enough to get a contract. Unless you are in a market experiencing multiple offers (when was the last time you saw that?),

you will have to either lower your listing price or offer to pay buyer closing costs. This last ploy is especially important on the low end, where buyers might have good credit and income, but no cash. Your ability to “help” them buy the property will put you in a more competitive selling position, and guarantee shorter time on market. Just assume you are going to pay them (because you are), and figure them into your list of expenses.

D. Profit (Or, the value of your time). This is the last number you will need to establish, and it is related to a lot of things, all of which are pretty subjective. I have had clients who have established a rule that unless they made a 50% return on their investment, they wouldn't enter the market. As you can imagine, they are all looking for that “once in a lifetime” property, and have been for years. In ten years and over 30 properties, I can report that I have found two “deals of a lifetime”. If you are not a Realtor, I can pretty much guarantee that you won't even have that kind of “luck”, since they get most of the screaming deals before you'll ever see them. It's really a question of whether you want to work hard for a good return or wait for a great return. If you have other employment on the side, perhaps the later is not a bad way to go, but for my money, I'd rather be buying and selling than fantasizing.

So, how do you establish your minimum acceptable “profit”. I guess I can't really help you there. I have a policy that unless I'm really desperate, I won't accept less than a 20% return after all of the above expenses. This opens up enough properties to assure that I'm working and to provide a pretty good living. In a down market, that percentage might go up if prices haven't fallen substantially (remember market dislocations?), but by and large, this works for me. So much of this is driven by the local market that I would caution you to adopt this 20% rule (especially if you are not a licensed Realtor), but it's a pretty good benchmark for me. One final comment: if you are an avid reader of the myriad books on real estate investing, bear in mind that the reason these folks are writing books for you is that they are the extremely lucky ones who have been in the right place at the right time, repeatedly. You should be so lucky, but if you are, remember this; the real money is to be made in writing a book!

Conclusion. So, you've done due diligence and run the numbers and have established a “minimum acceptable purchase price”. This is the price that you would be happy to own the property at, the price that should return to you your acceptable profit after normal expenses. It goes without saying that this is not necessarily the price you should offer. If you can get it at a lower price, go for it! It's all gravy. But, it at least will provide a fantasy-busting, pragmatic limit past which you just shouldn't go. Think of it as a little discipline, something every buyer of anything needs from time to time.

## 6. One step at a time

Like anything else, learning the skills necessary to be a truly effective and efficient “fix and flipper” takes time. Woe to the ambitious soul who doesn’t realize that all skills are learned progressively, and that mistakes are learning in action. Somehow, I got it right from the beginning, although I’m sure it wasn’t purposely. In retrospect, I think I bought my first project because it was the cheapest thing available, and I had only limited start-up cash. But luckily, because it was so inexpensive, it was pretty small, and it really didn’t need a whole lot of work. While working through it and the next few homes (which were, of necessity, the same type of project), I began to realize that the smart was to build my business, and my skill base, was to take on progressively more difficult projects as I went along. You might not be lucky enough to live in a city, where there is a lot to choose from, but if you do, I’d advise that you don’t overstretch yourself on the first home rehab. Try to take on projects that progressively challenge you, but don’t overextend you.

Think of it this way. Say you’re quite the painter, pretty good with laying tile, and a so-so plumber. Try to find a project that has two of those challenges and one or two other, new issues. As you move from project to project, if you consistently try to find one new thing to learn, or one fewer thing to farm out, you’ll soon be capable of doing anything. Which brings me to the next point.

If you find that your first project doesn’t necessarily return the gold mine you had expected, don’t panic! Common sense should tell you that as you go from project to project, you’ll not only acquire an expanded skill base, but you’ll get quicker and better at virtually every aspect of the process; quicker at finding homes, better at running the numbers, but, most importantly, more proficient at a myriad skills. It’s really a progressive thing, and, if you stick with it, you’ll find that you make more money with every project, turn them quicker, and have more fun doing it.

In addition to allowing myself one new skill to build with each new home, I allow myself one new tool per project! Think of it as a reward for a job well done! As time goes by, you’ll be renting fewer tools, be using tools that streamline and quicken the process, and teaching yourself to use more and more sophisticated tools. As I look back now, I can’t believe that I used to roll my paint jobs, or, later on, use a hand-held sprayer. It was appropriate for the time, but as time went on, I forced myself to buy an airless sprayer, and never looked back.

It’s all in the learning curve, but if you stick with it and push yourself consistently but not too aggressively, you’ll find that the work gets easier, the profits greater.

While we’re on the subject of tools, Addendum B has a list of absolutely necessary tools. Some of them are basic, run-of-the-mill tools, but some are “discoveries”. For instance, there is a wonderful thing that you can find in the

drywall section called a drywall square. It costs less than \$10, and I have used it for so many applications I can't believe it. Generally, it's a metal square, four feet long, that sits on your piece of sheetrock, reaching all the way across, and allowing you a quick, easy, and straight guide for your knife. I've used it for plywood, vinyl, any large material that needs a straight cut and has a machined edge. There are lots of little time-savers on the Home Depot shelves, and I'm sure that I haven't found most of them.

As your skill base expands, and your capital grows, you will very likely come to the day when you are starting to consider running two or more jobs at a time. Certainly, it makes sense, if you have the capital to do it, to be fixing one, buying another and perhaps have a third for sale, so that your downtime is diminished. All of this relates, of course, to your long-range business plan and your threshold for pain, but, unless your efforts at fixing and flipping are casual or intentionally part-time, there is a lot of potential out there for growth. Taking on multiple projects can be considered a middle step for those who wish to go the whole way. Beyond that is the next decision point; whether to farm out work to others so that you can have many projects going at once.

Certainly, climbing up this ladder is a logical thing to do, and we all have our favorite rungs. Suffice it to say that the further up you go, the more time you will be spending on bookkeeping, taxes, employee relations, banking and finance, insurance, Real Estate, and a variety of traditional management skills. You will probably also be making a lot more money and most likely have a lot less fun. It's a personal decision, but one not to be made without the family's input and a lot of soul searching.

## **7. Get Smart**

We've decided that there's a lot of wisdom in building our skills progressively, in becoming more and more sophisticated in both our approach to our projects as we progress and in the tools and methods we bring to them. But, new techniques and abilities don't just sprout from the ground; they need to be acquired. So, where/how do we get the information we need to dare take on a progressively sophisticated set of new skills and work with an increasingly complicated set of tools? This chapter is about getting help, most of it for free, and it's surprising how much of it there is out there if you're willing to look, be a little humble, play dumb occasionally, and take some time to invest in your own improvement.

When I started out, you couldn't find a knowledgeable "expert" at Home Depot if you were willing to pay for one. Fortunately, things have changed, and it has been my experience that good advice can be found in those halls (and, in the interest of equal time, at Lowes as well), and it's all FREE! Many of the department heads at our hardware mega marts are retired Pros, who, if properly sucked up to, can impart amazing knowledge, both about products, but more importantly, about technique. Take some time to find the floor people with real

experience (the contractor help desk is a great place to begin) and wait patiently while they counsel others. They can provide a wealth of knowledge.

Both Lowes and Home Depot also have regularly scheduled “classes” in all sorts of disciplines, from installing wood flooring to basic sheetrock technique, and , of course, they are free. Check their schedule boards and take advantage.

Another great source of free information, especially if you are a Realtor, is your own sphere of influence. Do you know of any home inspectors, contractors, handymen, builders? Take them to lunch and pick their brains. I remember in the beginning contacting a friend who worked for a builder in town. I asked if it would be OK if I spent some time in their development watching workers texture walls. She said “why not, knock yourself out”. After only a half hour watching the pros texture the best part of one floor of a new house, and another half hour reading the appropriate chapters of a Home Depot do-it-yourself book on walls and ceilings, I felt prepared to do my first texture job. Since then, I don’t do a home without a complete knock-down texture; it’s quick, easy, cheap, and it hides those thousands of little blemishes that are the bane of smooth finish wall guys (you don’t think they do textured walls because they’re so elegant, do you?).

There are hundreds of disciplines like this that can be learned by observing, asking questions, reading an appropriate book, and doing a test until you’ve got it right. And, there are a lot of professionals who are flattered by having you ask (in the right way) how something is done. They say that a little knowledge is a dangerous thing, but it’s better than none. Watching a drywaller many years ago for only an hour or so, asking the occasional question and taking mental notes turned me from someone who hated drywall into someone who took immense pride in his increasing ability to make a perfectly smooth wall. It took time, of course, but the ability to observe a professional in action, rather than try to learn it all myself, probably took years off of the process.

Public libraries are perhaps the greatest inventions of all time. And now, we have the internet! Both are amazing sources of totally free information and unlimited “how-to” sources for the beginning home rehabber. There is really no excuse anymore for not consulting the appropriate source before you dive into a new discipline. Arm yourself with the information you need to get a jump on the learning curve. Then, go for it!! And, remember, there is nothing you can do to a fix and flip home that will make it worse, and there are few things you can do that can’t be quickly, easily and cheaply undone.

Finally, if all else fails (this is for the males in the audience), read the instructions. I remember once, trying to figure out what I had to do to put a tile floor over a vinyl floor that was glued to a cement floor. Now, I knew that tile went down beautifully over cement, but the problem was that the vinyl was so well glued that it just wasn’t coming up. After consulting the contractor’s desk, I was directed to one Arvid, who, after breaking his back in the flooring business for thirty years,

decided to go for the health insurance and paid vacation and work at Home Depot. Arvid took me directly to the tile department, where I pulled from the shelves a fifty pound bag of “thinset”, the mortar mix that is used to set tile. Turning it over, he began to read aloud the section of the directions on “applications”. Lo and behold, to my wondering ears came “for use over cement, concrete, tile, cement underlayment, VINYL flooring, etc. I couldn’t believe it! Yes, you actually can lay tile right over vinyl flooring, something I never would have believed, and something I never would have found out had I not found Arvid, who, opposed to my habit, actually read the directions.

Yes, guys, I know it’s hard, but there is a lot of good information in those labels, but it only works if you read it. When all else fails, read the directions.

### **8. Time is Money.**

Remember our little economics course, where we talked about “opportunity cost”? Well, it’s time to re-visit the concept, which could be equally called “time is money”. Every hour you spend on the job, improving a home, is an hour that contributes to your income stream. Every hour spent pouring over endless property listings looking for the “once in a lifetime” property is time wasted. We’ve mentioned this before, but let’s look at the concept from a micro-perspective.

You are working on an electrical receptacle. It is old, and was never attached properly to begin with. In order to rewire and re-attach it, you realize that you will need to run new wire from a junction box several feet above it and somehow fish in a two by four through the old hole to anchor the box to. You spend about a half an hour unsuccessfully trying to send the wire down the wall the old hole, but it always seems to go catawampus, and you’re getting frustrated. You try to fish in the piece of wood, but the old hole keeps getting beat up. On and on it goes; your frustration level increases and there seems to be no end in sight.

You’d be amazed at how many times people continue trying to fit a square peg into a round hole. I know this because I have majored in it. Hundreds of small, seemingly innocuous jobs grow into major nightmares, especially in older houses, or when you are on a deadline (or, we are talking about a plumbing leak!). After suffering through thousands of these unproductive experiences, I’ve begun to develop a sense of when something requires an “out-of-the-box” solution. My wish for you is that you, aware of the money that is being wasted trying to “fix” some old situation, equipment, pipe, or doorknob, will step back and realize that just ripping it out and replacing it with something new is, in the long run, the better approach.

Think about how it’s possible to spray paint an entire interior of a home in about three hours, but that it can take a half a day to repair a \$100 paint sprayer. What’s wrong with this picture? Remember the guy that said “don’t sweat the

small stuff”? In the fix and flip world, he’s right on the money. Frugality is a wonderful virtue, but only to a degree. The time spent being frugal is very expensive sometimes. Try to remember this important trade-off of time versus money next time you spend an hour trying to make the perfect miter joint in a piece of floor molding. That’s why they invented caulk!

I don’t think there is any other area of home rehab that can waste more time than plumbing. I look back in amazement at countless hours of wasted time trying to fix old plumbing problems with the same parts that failed in the first place; trying, against all odds, to tighten weld, and stretch parts that simply have needed to be replaced. Next time you’re in a crawl space, watching the spiders above you and feeling the wet ground below you, and you find yourself trying for the third time to weld a joint that just doesn’t want to cooperate, please try to remember “opportunity costs”. \$10 of new parts will save you hours of frustration, anger and discomfort. Trust me; I know!

Anyway, what about the electrical receptacle? Wouldn’t it have been easier to cut a foot-square hole in the wall, run new wire and buy a new receptacle that automatically fastens itself to sheetrock? For my money it is, considering that by now you’re a seasoned expert in quick, clean sheetrock fixes? Next time you find yourself lamenting that something is taking an inordinate amount of time, STOP, and reconsider the whole approach. If it takes a trip to Home Depot, put the new part on your list for the next shopping trip and move on to something else. Wasted time is a killer for a self-employed person (not to be confused with “down time”, which is something else). Time is all you’ve got, and, unlike a corporate job, you don’t get paid to go to lunch, chat with a cohort, make personal phone calls, etc. Guard your time closely when you’re on the job, and enjoy it fully when you’re not.

Here’s a related issue. How do you know when “enough is enough”? How perfect, how beautiful, how complete should your project be? You’ve accepted that it’s not your home, right? So, where do you draw the line? What level of acceptable is the right mix of time spent and salability? I’m not sure that I know the answer. But, here’s an interesting slant to the question. In every state that I’m aware of, home inspections are a standard part of the home purchase process. And home inspectors justify their livelihood by finding things to fix, repair, upgrade, investigate, etc. It’s their job. So, why not stop before you have done it all? For sure, no matter how hard you try to cover all the bases, your inspector friend will find something to vex you. So, don’t get obsessive before you list the property. Rather, be prepared for a sizable list of things to do after you have a contract. That way, you look wonderful doing them all, and you haven’t spent countless hours trying to figure out what Mr. Inspector will find before you are under contract, only to find that he’s found a whole new list anyway. Just a thought.

For my money, I try to keep the attitude that I (once again) am in the restoration business and not the renovation business. Especially with a 50 year-old house, it's just as ludicrous for you to approach the job thinking that you're going to render it "new" as it is for a potential buyer to expect it to be new. Certainly, there are buyers who want it all; and for them, there are new homes, at probably twice the price as your "pretty darn good" older house. Remember that the effort spent on the last 10% of perfection is most likely going to take two to three times as much of your time as that preceding it. Know when to say "stop".

We've alluded to this before, but it's worth repeating. You're not in this alone. Even if you choose not to have partners, employees, contractors, etc., you still have a lot of people sharing in your venture. Lenders, insurers, accountants, attorneys, Realtors; professional people invested in your success. The security that comes from developing good, solid and dependable relationships with these people is money in the bank. Constantly shopping for the best buy is, in my experience, counterproductive. When you have established a quid pro quo relationship with your "partners", it will come back to you in so many ways. Granting a favor here, stretching the rules there; all of it amounts to getting the job done faster, which, as we have seen, means, getting it done richer.

The same applies to contractors. In my world, I have always farmed out major electrical work, major plumbing work and roofing, because they require permits, and carpet and vinyl work, since I don't have the tools, the expertise, and since one error on a \$200 piece of vinyl costs more than \$200. I have used the same people for years, although I'm sure that I could find "cheaper" sources. But, they have come to my rescue time and time again, since they know that I'm an easy and reliable source of repeat business. We have a symbiotic relationship, and, to me, it's worth its weight in gold.

Let's talk a bit about selling strategy, specifically the whole interesting topic of "high price versus quick sale". As a Realtor, I'm constantly explaining to clients that in most cases, the lower the price, the quicker the sale. Especially since the advent of the Internet, an immense amount of data are available to prospective buyers, and the level of sophistication in the buying arena is as high as it has ever been. So, you can assume that the basic premise that the lower the price, the quicker the sale (in all but the most extreme markets) is pretty valid.

You've run the numbers based on a selling price that is equal to recent comps in your area. But, markets are fickle, and despite your best efforts at getting it "right", there will be times when your price isn't cutting it. Which brings up the classic seller's dilemma; do I cut the price, hoping for a quick sale, or hang in there to make sure I maximize my "profit". It's a tough one, and the situation is really not much different for you than it is for an seller, with one exception. In most cases, sellers have only one house to sell, and it's their principal residence. In your case, unless you are heavy with cash or have another job that pays as well or better, you are dead in the water until you unload the house. So, all other

things being equal, I'm an advocate of low price, heavy seller incentives and quick sales, rather than trying to hold out for a miracle. Carrying costs are real, and aren't limited to the cost of financing either. There are utilities, insurance, marketing costs, and they add up. In the end, it's all really luck tempered by experience and a good knowledge of the market. I can guarantee you that you'll have your share of quick sales and an equal share of losers, but trimming the odds by pricing aggressively is, from my experience, the way to go.

We've spent time earlier talking about the financial budget, trying to put into numbers, before the purchase, what the entire transaction will look like. I've found that it's possible to get the whole thing within about 10% error in a stable market in a fairly-large city. But, there is another budget that you need to consider; the time budget. As we've noted above, "time is money", and down time is not producing any income. Generally, the best advice I can give in this area is to try to always be aware of how easy it is to waste time. Schedule your shopping trips on the way to the project, or on the way home. Keep a running list of things you will need to get through the next day. Tell friends, who want to "help" and neighbors who have nothing else to do than to tell you about the people who owned the house before you, that you are working for a living, and don't have the time for their important input, and constantly think a day ahead, knowing what you will be doing tomorrow, and what tools, supplies, time, etc. you will need.

Let's spend a moment discussing work flow; the order of things that guarantees the most efficient way to rehab a house. By and large, this list is pretty intuitive, but it can't hurt to reference it here, as some major time can be wasted in doing things out of order. Here's how I approach a house:

1. Secure insurance
2. Initiate utilities
3. Close on the house
4. Secure house; locks, windows secure, crawl-space locked, exterior lights fixed
5. Heat and hot water, which includes repairing any plumbing that is needed to guarantee a good supply of hot and cold water
6. Major demolition, removal of trash, anything unhealthy, dangerous, etc.
7. Strip house to minimum; those things that are staying
8. New windows/doors as needed
9. Patch walls, ceilings, prime, texture, paint
10. Concentrate on Kitchen and Bathrooms, one at a time so as not to impede water supply; work from top to bottom, floors coming last
11. Odds and ends; closet doors, door hardware, new fixtures, etc.
12. New carpet, appliances
13. Exterior cleanup, paint, etc.
14. Final clean-up.

If you are having any work contracted out, make sure you contact your workers well in advance of closing, and schedule them accordingly. Remember that an on-going relationship with roofers, carpet people, electricians, will give you advantage in the scheduling process, but be careful not to take advantage of the fact that you supply repeat business. Relationships work both ways; give your contractors time to schedule you, and then expect them to perform as promised.

One final time-management tip. In my case, fixing and flipping is a part-time avocation; Real Estate being the other part of my life. I originally got into the home rehab business because I couldn't make a living as a new Realtor, and found that I had a lot of free time on my hands. Buying homes and rehabbing them seemed like a good fit. Over the years, I've developed a day that is usually 50% Real Estate and 50% Fix and Flip. It works well for me, but it takes some severe time-management attention.

On a typical day, I'll do office work from 8AM until about 10AM. Then, I'll conduct whatever Real Estate business I've got "on the road" until about Noon. Then, a quick lunch in the car on the way to Home Depot, and arrive at the Fix and Flip project at 1PM. I work there until 5 or so, retire to a local pub, and do an hour of computer work, e-mail, reading and preparation for the next day. I keep work clothes at the fix house and, on the rare occasion that I have a late afternoon client meeting, shower and change back to my "professional" clothes at the project.

In order to pull this off, I have needed to stay very strict about what I'm doing when, and I've found that most people will respect the fact that I'm not always available to them; indeed, it seems that in the Real Estate world, being unavailable might even deliver a message of "I'm very busy", which can translate to "I'm very successful; you're lucky to have me."

If you intend to do your fix and flips full-time, you still need to be ever-aware of your use of time. If you are constantly leaving the project to shop for supplies, do personal things, or any number of other distractions, you are not using your time well. Plan to shop enroute to your project, schedule personal shopping and chores for the weekend or late afternoon, and cut the killer lunch meeting out of your life.

Finally, if you expect to have a full-time day job and conduct your investment property work during evenings and on weekends, time management becomes even more important, as you, by definition, have limited time for the project. Use your daily lunch hour time to do your shopping; clear out your trunk to accommodate supplies; keep food and drink at the project so that you're not having to leave when you get hungry or thirsty. In other words, give some serious thought to maximizing the little time you have. Remember; time is money.

## FINANCING

I guess that it's high time to deal with the financing of these properties; it is one of the most important steps in the process, and this is the chapter about "money". First, the disclaimer—I'm not a lender. That being said, I've financed over thirty properties. That being said, I've only taken a mortgage on one of them.

But, we're getting ahead of ourselves. Let's take a step backward. First, for all practical purposes, there are really three ways of bringing funds to a closing; paying cash, obtaining a "mortgage", or obtaining a "line of credit". All three have plusses and minuses, and the decision of which is both a matter of comparative analysis and also of practicality.

First, cash. If you've got bundles of it, it's definitely the easiest way to purchase any kind of property. There are no costs involved, you have complete control of the process, and you can close amazingly quickly. But, bear in mind, using the concept of "opportunity costs", that, even if you are lucky enough to have gobs of cash in the bank, it might not be the most expeditious way to buy your asset. There are times when interest rates are low relative to investment rates. At such times, it might be worth your while to invest your cash, yielding, say, 8%, and take a 6% mortgage. Even with the closing costs involved in the mortgage, it might be wiser to borrow if long-term mortgage rates are lower than short term investment rates. The moral of the story is that all money has a "cost" associated with it, and it's definitely in your interest to "run the numbers".

For most of us, bundles of cash aren't lying around, and so we're relegated to more traditional methods of financing our investments. If you've read any of the hundreds of books about Real Estate financing, you are probably convinced that taking a 100% mortgage on your investment is the way to go. Certainly it's better to "leverage" other people's money than to invest your own, right? Well, not necessarily so. The problem is that those books are all written with an eye toward long-term investing, and, in that case, it is usually prudent to leverage as much as you can when buying Real Estate.

But, you are not going to hold this property for long (hopefully). And so, in this case, the conventional wisdom might not be the best alternative. Turns out that there are very few books written about the wonderful world of "short-term" financing. So, with the help of our Addendum A, let's try to delve into our third possible source of funding; the line of credit.

Basically, a line of credit is a pre-approved loan from a bank or other lending institution at an interest rate that is usually pegged to the prime lending rate, or some other such short-term rate. Before we get into how they work, we need to take a short-cut into the world of interest, since, due to the notoriety of the "Fed", we're all subject to exciting speculation every few months about "what the Fed is going to do to interest rates".

First of all, **there is no relation between what the “Fed” does to interest rates and the rate of a typical mortgage**”. Isn’t that amazing? Well, it’s also true. When the Fed meets to discuss monetary policy, their main focus is on what is called the “inter-bank lending rate”, the rate the Fed charges banks (and banks charge each other) to borrow money for one day. When you buy a house with a mortgage, you are borrowing from a lender who is committing to lend you money for thirty years. In the mind of a lending institution, what happens tomorrow and what will happen in the next thirty years are completely different things. One is a short-term rate and the other is a long-term rate.

However, that short term rate does have a profound impact on short-term loans, as many of them are linked to either the “prime”, the “libor” (London inter-bank overnight rate), or some other short term rate; and those rates are indeed related to the Fed’s activities. The reason that this is important to us is that we are going to talk here about the difference between long and short-term financing, and which is better. It’s important to know that the most critical difference in these different financing vehicles is that their interest rates are different; one (line of credit) is a short term instrument, and the other (mortgage) is a long-term instrument. Also, since we’re in a period of rising default on “variable rate” mortgages, I thought it instructive to mention this short-term, long-term difference, as most of the mortgages presently in trouble have their rate adjustments pegged to short-term indicators like the prime rate. Finally, I just thought you’d like to know.

So, assuming you aren’t buying for cash, which of these two approaches is the best? As with anything in economics, there is no one right answer. But, given that you know some critical details about your approach to your business, there is a way to figure out which is best for you at the time. There are two noteworthy differences between a mortgage and a line of credit. First, the mortgage rate will almost always be lower. Second, the closing costs of a mortgage will almost always be higher. So, you begin to see that there is a “tradeoff” between these two variables. Look at Addendum A. We are assuming that we can find a 6% mortgage with about 2.5% closing costs, which is pretty typical these days. Also, we are assuming a line of credit with no closing costs at prime plus 1%, which is also pretty typical. If you do the math, it turns out that the break-even point between these two loans depends on how much money you have put down on the mortgage scenario. If you can afford 20% down, it makes more sense for you to mortgage the property than finance with a line of credit if you plan to hold the property for more than 6 months, because by the end of six months, you will have saved enough money with lower payments to recoup your outlay of closing costs.

If you put less down, you finance more, and your payments go up. So, it only makes sense to go the mortgage route with 10% down if you plan to hold the house for at least 8 months. At less than 20% down, you also might find you are

saddled with the famous “mortgage insurance” payment, which would make this period a bit longer. So, in review, the decision is really a question of how long you plan to hold the property and the relative spread between short and long term rates at the time you buy.

One final comment about lines of credit. In most cases in this business, they are the way to go. But, they do need to be “secured”. So, if you have \$100,000 equity in your personal residence, most banks will extend a line to you for about 80% of that, or \$80,000. If you don’t have that kind of equity, you’re pretty much saddled with a mortgage. But, if you do have some “collateral”, it’s possible to finance your first home with a line secured by your collateral, and then, once it’s fixed up and on the market, pull a line on your project to help you buy the next one. I’ve been doing this for years, and in some cases, have only used the second (or third) line for a month or two, and my bank only asked that I pay the “pre-payment penalty” of \$500 when I retire the line secured by my investment, which is paid at closing. In the meantime, the line secured by my residence is available forever, and I only pay interest on the funds when I use them. I have even negotiated a deal with my bank to forego the “pre-payment penalty” in lieu of a quarter percentage higher rate on the line, but this sort of arrangement is something that grows out of a mature relationship with your banker. Indeed, many bankers won’t extend lines of credit on fixed-up houses for sale, or vacant investment properties of any kind. Interview your bankers, and offer to keep your personal accounts there if they are willing to be “creative” with you.

Finally, I have heard of some “loan brokers” who have special products made for the fixer upper, but I have never used them, as I find that my lines of credit work better. In general, these products allow you to roll the cost of materials into the loan, which is a sweet deal. They also set their rates with the knowledge that it’s to be a short term loan, so between the increased rate and some rather high closing costs, these don’t seem to make sense to me. If you have absolutely no cash, these could make sense; especially to finance a first-time project, but be sure to factor the increased costs of these loans into your budget. Ask your Realtor to recommend a good, reliable loan broker, as there have been instances of less than professional behavior in the loan brokering business.

## **9. What goes around comes around.**

This segment is about how there are several peripheral benefits to being in the fix and flip business, especially if you are a practicing Realtor.

First of all, when you list one of your properties, the sign has your name on it, and, as with any listing, there is a small chance that you will pick up a buyer off of your sign. But, it goes beyond that. I have a sign that goes in the yard on closing day, which says “another project by Phoenix Restorations—For sale soon, call David Ball, etc.”. Duh! Real Estate 101. For some reason, it’s far more effective in generating leads than a For Sale sign has ever been for me. Now, of course,

there is the problem of conflict of interest; you can't represent a buyer when you are a licensed Realtor and you are the seller/owner; or at least you shouldn't represent him/her. But, at least in Colorado, that shouldn't stop you from allowing him to buy the house. I refer the potential buyer to a lender and an attorney. I explain that there is a conflict of interest, but that if he/she is comfortable with using an attorney, I can discount my price a bit, and we all can win. After rehabbing 30 homes, I must admit that I have never successfully consummated a buyer under this arrangement, but perhaps it's that I can't totally buy into it.

More interesting, however, is the situation where Mr./Ms. Buyer ends up as my buyer, but for a different property. I explain that I am a Rehab expert and a licensed Buyer Agent, and tell them that if my property is not ideal for them, I can sure help them find one that is. I have indeed converted several cold callers in this manner.

But the ancillary benefits don't stop there, not in the least. Shortly after entering the Rehab field, I found that I had to become the HUD/VA, distressed property "expert" in our office, which is a pretty high end office with seasoned veteran Realtors who, because of the recent boom in Real Estate, hadn't done a HUD or VA Repo deal in a decade. Their inherent distaste for distressed properties, coupled with their fear of the unknown and the fact that HUDs are now internet-driven, was too much for them to deal with! I merely placed a "HUD/VA Expert" sign in my office, and the referrals started coming in from my co-workers. Sweet deal!

While we're on the subject of HUD properties specifically, although it's beyond the scope of this article to explain HUDs in detail, let me say a thing or two in defense of HUDs. First of all, HUDs allow buyer's agents to charge up to 5% commission, no questions asked. Secondly, HUDs are priced off of an "as is" appraisal, and have consistently, over the past few years, been good, though not great (if you were around in the early 1990s, you probably know what I mean) deals. Third, HUD will usually accept offers of up to 10% below their list prices. And, fourth, even though there are definitely some challenges in the HUD process (everything must be JUST RIGHT, for instance), I find that the paperwork and the push to closing are at least no worse than our State contract process, and, usually, a lot easier. It's a great niche market, since a lot of Realtors just don't want to go near a HUD, and, once you learn the ropes, you can corner the market.

P.S. I have even had Realtors call me from competing firms, asking me to do their HUDs for them. Imagine that!

OK, back to the subject. So, you get a new buyer or two merely by being in the Rehab business. You become the office HUD/VA expert; perhaps you team up with someone in the office who does rentals and a reliable, creative lender, and

do a seminar for both of your client lists on the wonderful world of property investing. You get a reputation not only in the office, but around town as the “go to” Realtor for this particular corner of the market, you do a seminar for your local Board, perhaps the State Association. Really, the possibilities are quite astounding, if you care to go down that road.

Finally, there is nothing wrong with keeping in touch with your buyers, even if you didn't represent them, is there? You basically built their house, and, if they like it, they just might like you. Especially if they decide to enter the investment field themselves, or if they have friends who want to specialize in fix and flips, wouldn't it be nice if they knew how to get in touch with you? I've never spent much time on this, but it could be yet another way to leverage your expertise by generating more business in your “other” vocation.

One final point. After thirty rehabs, I have never had a buyer or buyer's agent come back to me with any negative feedback, or, worse, yet, a mediation or lawsuit. Certainly, when you are in this business, you are PERSONALLY involved in the property. You are not just the listing agent, or the owner; you are both, and, as a result, you are “exposed”. I think that the most important lesson that I have learned over the years in this business is that, in the long run, you merely need to be honest, forthright, disclose everything you possibly can, insist that the buyer get an inspection, and have as professional, upfront relationship with the buyer's agent as you possibly can. Let them know from the very beginning that it was a “repo”, that you did the work, that everything that needed to be done under permit was, and, if there are any lingering issues that you couldn't resolve, they are disclosed. This honest professionalism is not just a good way to do business, it is what you owe your broker, and it will let you sleep well at night. Don't take shortcuts. They have a habit of circling back to you!

## **10. Just Do It.**

Over the years, I've had lots of “investor” clients; people who have read a book or two, or love to watch the Home Improvement Channel and have some extra cash, or who are sick of getting slammed in the stock market. They come to me full of ideas and enthusiasm, looking for a “screaming deal”, and thinking that, since I do this for a living, I can find them what they are looking for. Invariably, what they are looking for is a home priced at least 75% below market with just cosmetic needs. I try to get them back down to earth with the “reality check” speech, and set them up on an MLS search engine that mails them listings that match their criteria as they come on the market.

Most of them I never hear from again. Some call from time to time and we go looking at the listings that have intrigued them. The scene is always the same; we enter the home, which usually has the basic problems; bad smell, holes in the walls, stains on the carpets, mold in the kitchen and bathrooms, doors hanging off of the hinges, no appliances, and they scream “oh, no, this won't do at all!”

I think that of the thirty or so “investor” clients I have had over the years (and it certainly could have been more, but I’ve become much more guarded of my time), two have actually bought properties, and one has started making a part-time living as a fixer-flipper. The rest are still waiting for the “screaming deal”, which, most likely, they will never find.

There are at least two reasons why they don’t accomplish their goals. First, the books they have read or the shows they have watched are based on false premises. Sure, there have been people who have been just in the right place at the right time and who, by virtue of lots of working capital, guile and tons of sheer luck, have really made it big in the rehab business. And, those are the people who write the books, encouraging everyone to be as lucky as they were. In reality, it doesn’t work like that. You start from the bottom up, and if you are lucky and work hard, you win more and more. People hear of you and send you information about houses coming on the market. Your capital grows, your skill set get broader, and little by little, you begin to make a good living. If you are really ambitious, you take on some financial partners, hire hourly workers, get a Realtor license, and get into multiple properties. But that all takes time, and it doesn’t work until you GET STARTED!

It all reminds me of the old Saturday Night Live sketch called “How to make a million dollars.” First step; Get \$500,000. Second step; invest it in a perfectly safe investment at 20%. Third; wait for four or five years. Presto!!

The second reason that you aren’t going to find the deals you have read about is that all of the Realtor/Investors have scooped them up before they even come on the market. Sorry to say, but you, the beginner, will be blessed with the crumbs, unless you are lucky enough to have a friend/relative, etc. who just happens to know of a little old widow who hates Realtors and just wants to get enough money to move into that nursing home by selling you her house. In ten years of buying investment properties, I’ve probably have two or three deals that were “just too good to be true”. The rest were pretty good, delivered some OK numbers, and made me a nice solid return on my investment. If I had waited for those two or three screamers instead of working for a living, I would have been bored, frustrated, and probably would have lost interest. So, Just Do It! Find a good project that fits your talents, buy it, and get to work.

If you are beginning, it really can be a bit scary. Did you get a good price? Will you be able to get the work done on time and within budget? Will it look good enough when you’re through? Will you be able to sell it? It’s enough to give you an anxiety attack. But, here is good news. In ten years of doing between 3-5 projects a year, I have **never** lost money. Some have been great; others pretty good, others not so hot, but all of them have given me a net return on my initial investment.

Here's another tip to hopefully give you some peace. There is virtually nothing you can do to a beat up house that can't be pretty quickly righted by someone else for very little money. I mean, think about it. Most of the major damage is already done by the time you get there. Short of burning the thing down (and you are insured after all, right?), what are you going to do to devalue the property? Know where the electrical breaker box is, the water and gas shut-off, have a fire extinguisher and first-aid kit at the ready, and GO FOR IT!

Remember, that as a Realtor (if you are one), you have a 6% advantage over those who aren't. You are paid 3% to buy the thing and you pay 3% to sell it. Your cash outlay is zero. Without your license, you buy it for free, but you sell it at a 6% commission to your Realtor. You are 6% worse off than if you hold your license. AND, it's not 6% of your profit; it's 6% of the TOTAL VALUE. If you buy a house for 100,000, spend 20,000 on materials, inspection items, insurance, holding costs and concessions to your buyer and sell it for 140,000, you net a profit of \$20,000. But, if you are paying a Realtor to sell it as well, his/her commission is 6% of the 140,000, or \$8,400, and your profit is cut from \$20,000 to 11,600, effectively a 42% cut in your profit! Pretty sobering, huh?

Of the two clients I have had grow into successful fixer-flippers, one is now studying for his Real Estate license and the other has taken the "for sale by owner" route. Both are starting to make some pretty good money. The "for sale by owner" guy is a full-time teacher and doesn't want that to change, and so has limited time for his investments. He has accepted that he will only do one, perhaps two, projects per year, and so he has extra time to sell his projects. Smartly, he also prices them very competitively, knowing that he can't afford 6-12 months of advertising expenditures, and that he will have a limited pool of buyers, all of whom, knowing that he is selling "by owner", expect that all of the money he is "saving" by not having a Realtor should go to them. So far he's done pretty well, but I think you can see that he has a tough selling job, even in a strong seller's market.

The Realtor candidate is a full-time, most unemployed contractor with a father/partner who has pretty deep pockets. It makes perfect sense for him to take a couple of months studying up for the exam (at night) and to hang his license in a low-cost office. He's planning to do this pretty much full time, and so his ability to find property quickly, and move it as quickly, is crucial to his business plan. And, by making the investment in time and money up front by going after the license, he's guaranteeing himself a better, more consistent return and shots at much more profitable purchases for years to come.

In the long run, I guess it depends on your situation, but the difference in profitability is so great on just this one point, that you need to really give it some thought, and be sure to re-visit that decision as your situation and circumstances change over time.

And so, we come to the end. Hopefully, this little treatise has helped intrigue you, if nothing else. I've tried herein to keep focused on the "business" of fix and flips, and not on the actual, physical work, so perhaps the title "the nuts and bolts of fix and flips" is a bit of a misnomer. But, I truly believe that the money is to be made in a strong business plan, good partners, a sense of reality and proportion, good self-knowledge, enough curiosity and humility to ask questions, and a good, pragmatic sense of the value of time versus money. It doesn't lie in how fast you can paint a wall or fix a toilet. Those skills can be built, and will be built quickly, once you get to work.

Remember, the difference between your dreams of money and the money of your dreams lies in getting started. Everything else will work itself out. So, **JUST DO IT!**

## Addendum A Two financing alternatives

|                               | Conventional* |   | Line of Credit** |        |
|-------------------------------|---------------|---|------------------|--------|
| Price of House                | 100,000       |   | 100,000          |        |
| Down Payment                  | 20,000        |   | 0                |        |
| Loan Amount                   | 80,000        |   | 100,000          |        |
| Closing Costs                 | 2,000         |   | 0                |        |
| Interest Rate                 | 6.0           |   | 8.0              |        |
| Pre-pay Penalty               |               |   | 500              |        |
| Monthly Payment               | 400           | - | 666              | = 266  |
| Cash Outlay                   | 2,000         | - | 500              | = 1500 |
| Months Break-Even at 20% down |               |   |                  | = 6    |
| Months Break-Even at 10% down |               |   |                  | = 8    |
| Months Break-Even at 0% down  |               |   |                  | = 12   |

\*2.5% Closing Costs, No MIP, Rate fixed at 6.0% interest only

\*\* 80% of security value, \$500 pre-pmt in first year, prime plus 1%

# **Addendum B**

## **20 Really Cool Tools You Must Have**

1. CATSPAW (Nail Puller)
2. AIRLESS PAINT SPRAYER
3. SAWZALL (Reciprocating Saw)
4. TEXTURE MACHINE
5. CIRCUIT TESTER/STRIPPER
6. BATTERY POWERED SCREWDRIVER/DRILL
7. SHEETROCK TOOLS
8. 4 FOOT SQUARE
9. MAPP GAS TORCH/WELDING TOOLS (No Propane!)
10. BIG MUTT (Big Blade at the End of a Handle)
11. SKILLSAW
12. FRAMING HAMMER
13. WONDERBAR (That's Wonderbar)
14. SHOP VAC
15. TILE SAW
16. AIR COMPRESSOR/NAIL GUN(S)
17. CHANNEL LOCK PLIERS
18. MASKING MACHINE
19. FIRST AID KIT
20. REFRIGERATOR FILLED WITH BEER

# Addendum C

## Evaluating a Potential Project

Average Comparable Value When Finished  
150,000

|   |        |
|---|--------|
| Cost of Materials/Equipment               | 7,000  |
| Holding Costs (Debt Svc., Utilities, etc) | 3,500  |
| Concessions to Buyer                      | 3,000  |
| Commission to Buyer Agent                 | 4,500  |
| Commission to Broker                      | 1,000  |
| Value of your time (Profit)               | 15,000 |

Total Expenses  
34,000

Maximum Acceptable Purchase Price  
116,000