

Should You Rehab SFHs or Rental Properties?

For investors already doing rehabs, this is not much of a question. They will continue to do what they know and feel good about. For other investors who are looking to do rehabs or have only done a few, this question should be very important to their profitable future.

Single family homes run the gauntlet from rehabilitating slum houses to waterfront ocean properties. Some people might say that the only difference is a few zeros in their prices, but more is involved for the new investor. For this discussion let's compare "bread and butter" houses with duplexes and triplexes in the same social-economic neighborhoods.

The even better analogy is that the rents of the duplexes are equivalent to the rentals of single family homes (SFHs) that a rehabber would fix up and sell. These properties will usually be in different neighborhoods, but the income comparison is more important.

Let's first look at a typical SFH that the rehabber buys for \$80,000 and wants to resell for \$140,000. We will further assume that his rehab and carrying costs equal \$30,000 so he is looking to net \$30,000 before closing costs. This example is just that, not a real property that you might buy for \$30,000, rehab for \$20,000 and sell at \$100,000 – it's just an example!

The issues the rehabber faces when he gets his property ready for sale is finding a buyer and getting financing for that buyer. For very astute rehabbers, the problems with appraisals and qualifying a buyer for a conventional mortgage is not an issue whatsoever. For the average rehabber, he has to contend with picky buyers, possibly paying a Realtor® commission, getting the prospective buyer qualified for conventional financing and fighting to get his deal closed.

Because of the mortgage meltdown, all lenders have changed their criteria for loaning money and many banks have stopped lending but won't admit it. You find out when you send in a mortgage application for your buyer who should easily qualify for the loan but gets turned down for some obscure reason!

Let's compare this rehab with a rental income property, specifically a duplex or triplex that produces total gross rental income of \$1,500 per month. In some areas of the country this income could be \$1,500 a unit or \$600 for all the units combined. The exact amount doesn't matter because the price of the building will adjust for the rental income – unless you overpay when you buy it. I picked \$1,500/month because that's about what the house above might rent for in the same area.

What is not obvious and is critical in this real estate market is that the above rehabber may not be able to sell his newly rehabbed property so he decides not

to take a lower price and becomes a reluctant landlord until the market turns up. After all, "Why not sit on a property that is throwing off cash every month?" The answer to this is simple, because you don't have the ability to turn the capital locked in the property! So much for rehabbing the next property unless you have private lenders to support you – or should I say, be willing to hold your losers?

The rental unit's purchase price can be determined by doing a reverse yield calculation. This essentially says you want to purchase the property at a price to yield a 20% - 25% net return before repairs. The repairs are a critical part of the equation and should be estimated as accurately as is reasonable, but don't spend hours doing it.

We figure \$5,000 per unit as a rule of thumb for "move-in" condition for patch and paint, new floor coverings and for putting in used appliances, but without roof replacement. With roof and ceiling repairs and central air conditioner/heater replacements and unexpected "stuff", figure \$10,000 per unit. Actual repair costs including electrical panel replacement and structural issues should be reflected in a lower offering price to the seller.

Using an actual example of a property we did recently, we purchased a triplex for \$75,000 that was three 2 bedroom and 2 bath units. The roof was in excellent shape, no work needed, and the floors were tile, so no added costs there. However, the kitchens and bathrooms had to be updated in each unit for a total additional cost of \$28,000. With closing costs, the total cost of the property was \$105,000. Rental income is \$900 monthly per unit with Section 8 tenants. This property was previously financed for \$325,000 in 2006.

If we calculate the above rental income less expenses of a 10% management fee, insurance, annual taxes, insurance and miscellaneous expenses, the net income to the property owner is 22.78% annually. However, as soon as the property is rented, if we then sell it to an investor who wants rental income for a 15% net annual return, the sale price will be \$160,000. While this seems absolutely great, and it has been for us, the neighborhood may not support this high a sales price if it is blighted. If the rental property is kept full, a foreign investor should only be concerned about his monthly check. You also have the opportunity of being the property manager for these rehabbed units if you are licensed to do so.

The buyer may well be a cash buyer or have a substantial down payment. Foreign buyers are getting a double advantage with a currency play in the dollar so buying now and selling when the dollar rises in the future will also make them money. These rental yields exist because so many landlords over mortgaged their income properties and are losing them to foreclosure and short sales. The above actual example was a short sale from a former landlord who had five of these triplexes next to one another.

If you rehab and sell a SFH and it cash flows with an 8% plus yield (CAP Rate), it is a gem to foreign investors. The reason is that home prices are the lowest in 10 years in America and will increase sometime in the future. By sitting on a “good” yield and waiting for the real estate market to gain in value, these foreign investors have a safe haven for their money and a built in appreciation.

So as can be seen in the two examples previously, the rental income property was a “better” rehab from a profit sense. It also would not have the same problems of qualifying a buyer as SFHs. The actual answer to this dilemma is to look at rental properties to rehab and work the yields backward to see how much of a spread you can get from rehabbing and flipping to a prospective landlord versus doing a SFH of similar cost, similar rehab expenses and similar rental income.

Currently, foreign money seems to be migrating toward SFHs more so than multi-family rentals. These buyers are being shown more SFHs than rentals but they may also believe they can get a good return on their invested dollars for a few years and then sell as the housing market comes back. This thinking is correct as there is a limitation as to how much multi-family properties can appreciate even with rental increases.

As always, buying at the right price and being effective as a rehabber is critical to your success in this business. If you wholesale, you can use the yield “play” to sell your properties to prospective buyers. As a general guideline, I have noticed that we are taking out net profits on sales of multi-family unit’s equivalent to one to three years of gross income. For example, if the property’s gross monthly income is \$1,400 a month combined for all the units, a year’s income would be a \$19,600 profit on this wholesale deal. If you wholesale for \$3,000 spreads, that is your choice and you are paying too much to begin with for the property. In the final analysis, you will have to do six times as many deals to make the same money we are making – the choice is yours.

I had a student tell me that she was pricing the deal she just got based on the ARV minus repairs costs less her profit spread and a profit spread for the rehabber. One mistake I see investors make is they try to figure repair costs for their buyers. One buyer will see \$20,000 in repairs in a property and another will see \$50,000 for the same property. The actual repair costs could be \$10,000 to the right rehabber who does the work himself. While repair costs are important don’t let them hinder you from offering your wholesale property at a higher price than you think it is worth. Spend your time marketing the property instead of over-thinking yourself out of a deal.

To your limitless success,
Dave Dinkel