5 Things to Do Before Investing in Real Estate

Brian T. Boyd, ESQ.

Investing in Real Estate is akin to diving down a rabbit hole in that you have no idea where it will take you. Thus, preparing to invest in your first property should be approached with a plan. As you begin your journey into real estate investing, you may be nervous, anxious and possibly a little scared. Those are perfectly normal feelings – after all, you're learning something new and it's going to be a big investment. Don't freak out. Breathe. You're going to be just fine. In fact, you might really enjoy this journey.

In preparing for this first investment, there are five things – let's call them "action items" – you can do to prepare for this new world. I have set these action items out below, in no particular order. Once you see them and start using them, they will be a simple part of your processes for every deal, whether you realize you are doing them or not.

1 DECIDE WHERE YOU WANT TO INVEST

This is a question you will need to think about long and hard because it, like the other action items, will become interconnected in your analysis.

Buying in an area you know is helpful to you in that you're already familiar with schools, churches, businesses, entertainment and the seasons of the year. Understanding the community that you invest in helps you find the right kind of renters, thus, you will understand the socioeconomic demographics you are seeking to serve.

If you are thinking of investing out of town, you will need to learn about those communities. For example, if you are looking to invest in a ski chalet, a beach house, or a duplex in another town, what are the demographics that you are going to serve? Are you serving the servers, bartenders and ski lift operators, or the families and couples that vacation at those locations? Think about it.

In choosing a location, it will help you to learn about the rental regulations in those areas. If you purchase a house in a neighborhood, does that neighborhood have Home Owner Associations ("HOA") that allow properties to be rented out? If so, are there restrictions on the term of the leases? Many HOAs require at least 12-month lease agreements, some HOAs will outright ban Short Term Rentals (STRs). This factor will also impact your analysis of where to invest.

Choosing your location of investment is more important as you develop your own personal taste for real estate. Many people that self-manage their properties only buy in the towns or communities in which they live. Other real estate investors choose to invest exclusively out of town and turn over their properties to property managers.

A good example of out-of-town investing would be living in Atlanta, Georgia, and buying a beach condo on the Gulf Coast of Florida. That investor is likely going to put that condo on a STR rental program that will take care of the bookings, collecting the money, keeping up with the maintenance and paying the utilities for the investor. At the end of the month, the property manager will send the investor a check and report to review for expenses, bookings, and maintenance items.

As you can see, deciding on where to invest will be an important decision to help you in the preparation of your investing journey.

2 DECIDE WHAT KIND OF REAL ESTATE YOU WANT TO INVEST IN – LONG TERM OR SHORT TERM?

Long term or short term? That is certainly the question many investors have on their minds as they progress down the path of real estate investing. Deciding on a type of investment property is a hard choice. But looking at the pros and cons of each type of property may give you a better decision tree to help you.

LONG-TERM PROS

- Steady income stream
- Better price to entry
- Tenants pay utilities
- Tenants maintain property
- Long-term tenants tend to stay

LONG-TERM CONS

- Lower monthly income
- Lower return on investment
- HOA fees
- Major repairs (HVAC, roof, etc.)
- Evictions

These lists are not exhaustive for long-term investments. Additional considerations arise as you become more familiar with real estate investing, but these are good points to consider. In your consideration, remember, this is your personal choice and business plan, and you can change your mind at any time. Do not be afraid to change your mind.

Long-term rentals tend to remain consistent year over year since people tend to integrate into their communities. By becoming part of a neighborhood, tenants often desire to stay for longer periods of time. In doing so, they also have a vested interest in maintaining the property. Long-term tenants thereby become a stabilizing factor in the investment property. Long-term rentals are a good investment for long-term appreciation and for asset valuation.

Short-term rentals are neither better or worse, they are simply different. Below I have set forth some considerations to consider for short-term rentals as an investment property.

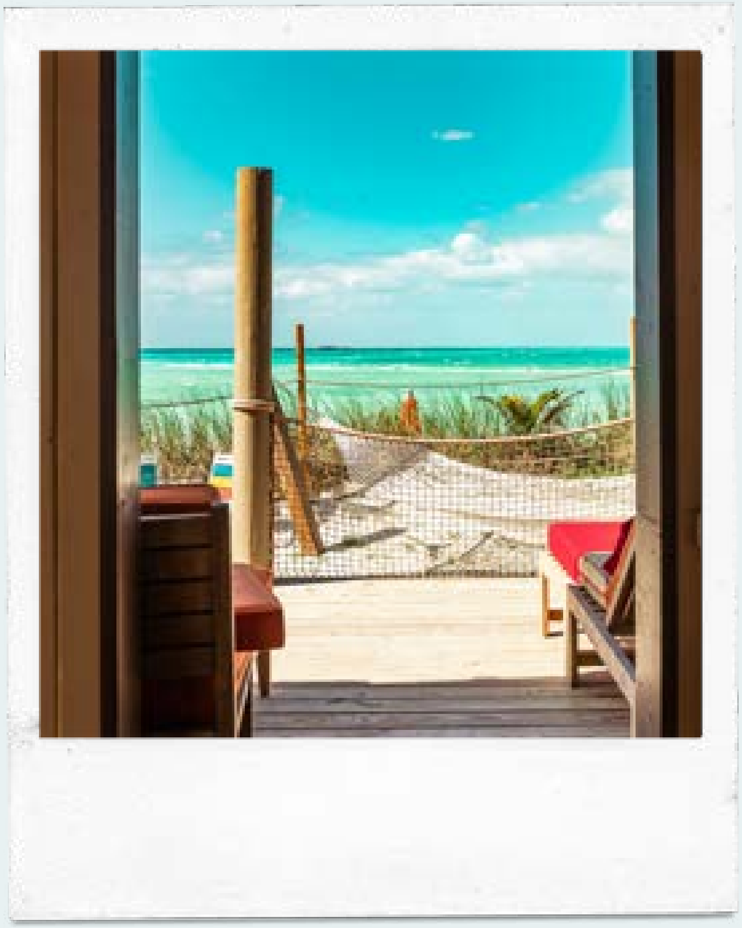
SHORT-TERM PROS

- Higher monthly gross revenue
- Valuation is typically tied to revenue
- Available for personal use
- Short-term rentals have looser tax rules
- Appreciation is steady

SHORT-TERM CONS

- Higher maintenance costs
- Monthly utilities
- Property management fees
- Book-keeping for expenses
- Revenue may be inconsistent

SHORT-TERM RENTALS CAN BE VERY LUCRATIVE.



That said, if you are going to self-manage your property, they can also be very time consuming when you have to prepare the property for a guest or have to clean up a mess a guest made. If you are not interested in doing those things, there are property managers that specialize in STRs, and they make your life much easier. In fact, in areas like Gatlinburg, TN, or Hilton Head, SC, you will find companies that only provide STR accommodations. Property managers make it easy for you to invest in vacation destinations at the beach or the mountains and do so even if you are in another state or part of the country.

> *Property managers can make your life much easier.*

One downside to these properties is that they tend to cost higher as an initial investment. In saying that, I am talking specifically about the investment world post COVID-19. Short-term rentals have skyrocketed in value. This is in part due to the fact that the hotel industry had to shut down for long periods of time. When the hotels closed, real estate investors saw a boom in bookings with people turning to Airbnb and Vrbo.

Property values doubled in some parts of the country, and prices ticked up for bookings. Such a turn of events resulted in what we now see as higher investment points for real estate investors.

Regardless of which type of investment path you choose to pursue, there are going to be good days and bad. Part of this decision is based on what your risk tolerance is. Both types of properties are good investments. Do some research about what you would like to invest in by considering these two types of rentals.

3

LEARN HOW TO VALUE AN INVESTMENT PROPERTY

Trying to gauge a property’s value in terms of what to pay for a property versus what will it make for you is a book unto itself. In fact, there are courses out there for real estate investors to learn how to underwrite a property. Underwriting a property is a very useful skill that will pay you dividends down the road.

There are many different gauges for measuring a property’s value, and those formulas can make your head swim. So, I will focus on what I call “back of the envelope” calculations that will help you figure out if you should consider a property for investment.

ROI = RETURN ON INVESTMENT

In the real estate world of investment, especially for long-term rentals, obtaining a 1-2% return on your investment is a really good deal. This means if you bought a house for $100,000 and *netted* $1,000.00 per month – after taxes, mortgage, insurance and maintenance – you will have made 1% of the purchase price of the house.

Such returns are becoming more and more difficult to achieve given the current real estate market and rising inflation and corresponding interest rates. However, those deals do still exist and you can find them in the most interesting places: tax sales, probate sales, foreclosures, other real estate investors looking to offload the property, and the list can go on and on.

The more common calculation is the capitalization rate, or cap rate. The cap rate formula is:

Cap rate = Net operating Income / Current market value

This formula takes the annual operating income and deducts the expenses for managing the property, and divides that number by the current market value or the purchase price of the property. The purchase price of a property, unless it is new, may not always be an accurate measuring standard for the cap rate, since the property may have been purchased some time ago and therefore may not reflect the market value.

Thus, following the first model, if you were to purchase a property for $800,000 and your NOI is $70,000, that results in an 8.75% cap rate. This is actually very good. Generally speaking, any cap rate between 5-10% is a good investment.

When these formulas are applied to short-term rentals, the profitability of STRs becomes evident, however that does not mean that long-term rentals are to be dismissed based on the formulas alone. Long-term rentals are a slow and steady way to achieve financial freedom, whereas short-term rentals can be seasonal and thus cause some personal discomfort in the seasons the property is not renting out. Just keep these formulas in mind when evaluating properties, and consider the types of properties you are applying these formulas to, either long-term or short-term rentals.

4 DECIDE WHEN TO INVEST IN REAL ESTATE

Investing in real estate is both a business decision and a personal decision. From a business standpoint, real estate is an industry unto itself with its own tax code sections to be understood and complied with. Further, real estate is vast in scope from commercial, residential, and all other forms, e.g., self-storage, mobile home parks, tiny homes, RV Parks, and others. Books have to be kept, depreciation schedules kept on each property, property managers managed, and properties maintained. Thus, real estate investing can be a full-time job – a hard one but also very rewarding.

On the personal front, an investor is going to have to decide what they want out of real estate investing. Do they want to simply put their money into a real estate deal and get a return with no day-to-day interaction, or do they want to jump in with both feet and run their own investments, or something in between? Fortunately, there is something for everyone along that spectrum.

> With the flexibility of real estate in mind, when is the right time to invest? To that I would answer you: now. Yesterday was probably better, but tomorrow is going to make today yesterday.

I say this with the knowledge that over the years, it has been shown that real estate goes up in value. Many people will remember the Mortgage Backed Securities crisis of 2007-2010, when insurance companies, banks, and Wall Street were brought to their knees over bad loans. That crisis led to many banking and lending reforms that have been regulated out of existence.

But, if an investor bought properties in 2010, those properties are worth a lot more today. In fact, if an investor bought properties in 2019, *those* properties are worth more today than they were when purchased. In saying this, I am obviously pointing out a truism that has been borne out over decades, if not centuries, of data. *To wit*, the stock markets in the United States have historically gone up year over year, and housing prices have historically gone up year over year. Even in years with recessions, stock market crashes, or the Mortgage Backed Securities Crisis, real estate has continued to increase in value over time.

> *What do you think your answer to this question is:* ***Will my property be worth more this time next year than it is now?*** *If you answered "yes," then you have your answer of when to invest.*

Real estate is one of the largest assets owned by individuals. It is also necessary. Our government has made a point to encourage real estate investing through public policy set forth in the Tax Code, 26 U.S.C.A. Within those 60,000 pages over 54 volumes, you will find deductions, credits, depreciation schedules, and other benefits that encourage real estate ownership and investing. Congress has stated time and again that real estate, home ownership, and development are vital to the health and safety of the citizenry. Investing in real estate is good for you and good for those you serve.

If now is the best time to invest, how much should you invest? That depends on your risk tolerance and if you are simply looking to diversify, or if you are looking to grow your own portfolio and set your own course. Take stock of your finances, look at the market and consider your options, then educate yourself through podcasts, articles, blogs, and get-togethers with others in the real estate world.

5 COMMIT TO SERVE

Throughout this writing, I have used the word *serve* intentionally. I do this because real estate investing is a service. Real estate investors provide service to their communities, to their tenants, and to themselves.

As property owners, we owe it to our tenants to provide solid, safe and healthy homes. It is our obligation to make repairs and be responsive to our tenants' needs for their homes. That is why they pay rent, and keeping that in mind helps us all be better stewards of our community.

As community members who own real estate, we become the voices of communities at city council meetings, at zoning board Meetings, to developers, to school districts, and to our neighbors. Investors who make communities better lift others and themselves in the process. Buying an old house and making it new again for a family to rent is a success story in the making. You will have provided a service to that family, to that community and to yourself. Yes, you will have a more valuable asset, as well. But, you will have become a community leader who has served.

> "Real estate serves us all in so many ways. It can build generational wealth, it can provide financial independence, it can provide a home to those that cannot afford to buy or who just choose not to. It can also be your legacy to others, in that you left it better than you found it and helped others along the way."

I reiterate service and serving because it is through serving that your investment will serve you through returns and profits. It's important to keep that in mind as you move along this path of real estate investing.

Many of the things discussed in this short writing are from the lessons I have learned along the way. These points are action items I deal with on a daily basis through my real estate investing and through my daily work as a lawyer. While real estate investing can be very hands off through the use of property managers, hard money lenders, and apartment syndication deals, I have yet to meet any investor that did not end up owning at least a few rental properties of their own.

With housing prices continuing to rise, there is a great need in this country for affordable housing. That market is underserved and is in desperate need of investors to build, build, build. In doing so, the investors will make nice returns and the tenants they serve will have houses to call home for years to come.

Those investors are people like you that are reading, learning and getting into real estate investing. You will have some great days and some terrible days, but on the whole, the good outweighs the bad and in the end when you take stock of your investment, you will see just how powerful real estate can be – financially and personally.

For those looking to learn more about real estate, I would recommend listening to the Bigger Pockets Podcast, The Real Estate CPAs, and Passive Wealth Strategies. All these podcasts are great places to listen to other investors and pick up nuggets of knowledge. I wish you the best of luck in your real estate investing. There are great things out there for you, go get them!

LEARN MORE

Brian Boyd is an attorney in Nashville, TN who practices in the areas of real estate, construction law, business and taxation. He is the owner and managing attorney at Boyd & Wills, PLLC in Brentwood, TN. He started investing in real estate in 2017 as a way to generate passive income. Since then he has taken a hands-on approach to his real estate investing and has advised other clients on the best ways to achieve financial independence through real estate.