



Real Estate: Real Money And Real Problems

By: Sara Clemence

The last property Giovanni Isaksen bought to fix up and resell was a “nice house in a nice neighborhood.” An independent real estate investor in the Seattle area, Isaksen and his partner figured they could sell the house for about \$850,000, so they budgeted for renovation accordingly.

But the market was strong, and soon it seemed they could sell the house for \$899,000, so they decided on more improvements. “By the time we got to market, people were going crazy,” he says. “Some said we could get \$1.2 million.”

In the summer of 2006, the house sold for \$920,000—more than they initially expected, but at little or no profit. “If we had stuck to the original plan, the thing would have sold in a week and we would have ended up in the same or a better financial position,” Isaksen says. “After we backed out the carrying costs, it was within dollars of where we originally planned to be.” The lesson, he says: “Plan your work and work your plan.”

Real estate is a common means of diversifying a portfolio and hedging against inflation. “As inflation occurs the value of your property will go up,” says **Todd Huettner**, president of **Huettner Capital**, a Denver-based real estate financing brokerage.

“Then there’s the financing. You’re borrowing dollars when they’re cheap today and paying them back when they’re worth less.” But depending on how you get into real estate, it can be a time consuming, complex and (as the recent bust proves) risky proposition.

There are many ways to invest—in properties or funds; in commercial, residential or industrial; in single-family homes or condos. Each strategy has advantages and disadvantages, but experts say there are a few principles that hold true across the board.

First, do your homework. “Don't feel obligated to do the deal if you don't have all the information you need,” advises Gregor Watson, managing partner at McKinley Capital Partners,

a \$30-million dollar real estate fund in California. “Just because it's free doesn't mean it's a good deal.”

That means examining market dynamics for the segment you’re considering, knowing how financing works, understanding all the aspects of the deal. “If it's outside your area of expertise, hire professionals,” Watson says.

Be skeptical of deals that seem too good to be true. “Be careful of the real estate agents—they're out to make a sale,” says Marty Sumichrast, an entrepreneur, venture capitalist and real estate investor.

And finally, expect things to go wrong. “What if you had a vacancy and needed a new roof and a water heater, all in 30 days?” **Huettner** asks. “If you see all the things that could go wrong, you’ll usually end up being okay.”

With those principles in mind, you need to figure out how you want to invest. That choice will depend on your personal and financial goals and predilections.

REITS And ETFS

George Van Dyke, an independent financial consultant in Towson, Maryland, advises his clients to use real estate investment trusts, EITS, and exchange-traded funds, ETFs, to diversify into real estate. The vehicles are fast and easy ways to get into different properties, geographical areas and real estate classes.

“With publicly traded securities you can remain liquid,” he says. “If you can't tolerate the risk, you’re not forced to go and sell a physical piece of real estate, which could take months.” It’s also relatively simple to limit risk by using a trailing stop loss order, which automatically sells an asset if it drops below a certain predetermined price.

“If the real estate investments we utilize go up for an extended period of time, it is possible to lock in years of gains,” Van Dyke says.

With REITs and ETFs, you don’t have any of the hassles or liabilities that come with being a landlord or a property owner. But some investors are looking to be more hands-on. And, Van Dyke notes, you may be missing out on some money. “The returns that you would get on a physical piece of real estate would exceed what you would get on a publicly traded security,” he says.

Residential: Single Family

For many, the next step up is investing directly in a property.

“Residential is the easiest and lowest risk,” **Huettner** says. “You don’t have to have a few million bucks to get involved, and you can get a 30-year fixed-rate loan at a really low rate, putting down 20 or 25 percent.”

The simplest approach is to buy a house or apartment unit to rent, especially since most of us are familiar with home ownership.

“If you're starting in single family, buy in the neighborhood you're working in,” Isaksen suggests. “You’ll know about the area. You’ll be able to get there easily.”

When looking for properties, consider how the home fits into the neighborhood and the current housing market. If a property is dirt cheap, ask yourself why.

“Is it because it's a three-story townhome in suburbia?” Watson says. “Don't just look at price. Make sure the product matches the market.”

Isaksen advises making sure you’re in the middle tier of the neighborhood in terms of size and price. “You don't want to be the highest end home on the block,” he says. “You don’t want to have to lead the market.” Keep in mind that single-family homes require hands-on management, and so are difficult to run from afar.

Also, make sure you’re okay with being a landlord. “Some people aren’t cut out for it,” **Huettner** says. “They don’t feel comfortable telling someone they’re behind on their rent.” Another potential downside: cash flow is all or nothing. If you lose your tenant, it drops to zero.

Residential: Multifamily

On the other hand, if you have 20 tenants and one moves out, you still have 19 others paying the rent, Isaksen says. Other pluses of investing in this category: your rentals are all in one location, so there is one lawn to mow and one roof to repair; if the property is large enough—over 80 or so units—you can hire a professional manager. “Then you're not in the landlording business—you're in the property ownership business,” Isaksen says. “You're not getting called at two in the morning to fix that toilet.”

On the downside multifamily properties are often more expensive than single family homes, and the financing is different. For one, loans are based on debt service ratios—an assessment of the cash flow rather than an appraisal of the resale value.

There are more financing options for loans over \$1 million, **Huettner** says. Local bank loans will typically be portfolio loans, and be 10- to 15-year fixed rate loans, which means high payments, or 20-year loans with balloon payments.

Commercial

“A lot of the residential investments on the market are foreclosures,” says Tim Grizzle, author of *Creating Wealth in a Turbulent Economy*, a CPA and a commercial real estate broker, registered investment advisor. “I just don't want that karma.” Another reason he invests in moderate-sized commercial properties is that the rents are generally higher than with residential properties.

Lending for commercial properties is based on the income the properties produce.

“Generally the income the property produces needs to be 1 1/4 times the debt service,” Grizzle says. Financing can be difficult to obtain these days, but private investor groups are a common option. “Basically you call everybody you know and ask if they know anyone who has money to invest.”

When seeking out potential properties, research local market dynamics—the commercial real estate saw is, “Retail follows rooftops.” Shari B. Olefson, author of *Foreclosure Nation* and an attorney with Florida-based law firm Fowler White Boggs, suggests strip shopping centers as an investment. Though retailers are not doing well currently, grocery stores, discount stores and drugstores are.

“Look for a local strip venture that you’re familiar with and has local businesses that people use and need,” she says. Also be aware that they need to be renovated every five to ten years.

But no matter what you’re considering, don’t be afraid to walk—for any reason.

“The best investment decisions are usually the properties that you turn away,” **Huettner** says. “There will always be other great deals.”

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