Why ReHab Knowledge is Crucial to Investors in Today's Real Estate Market

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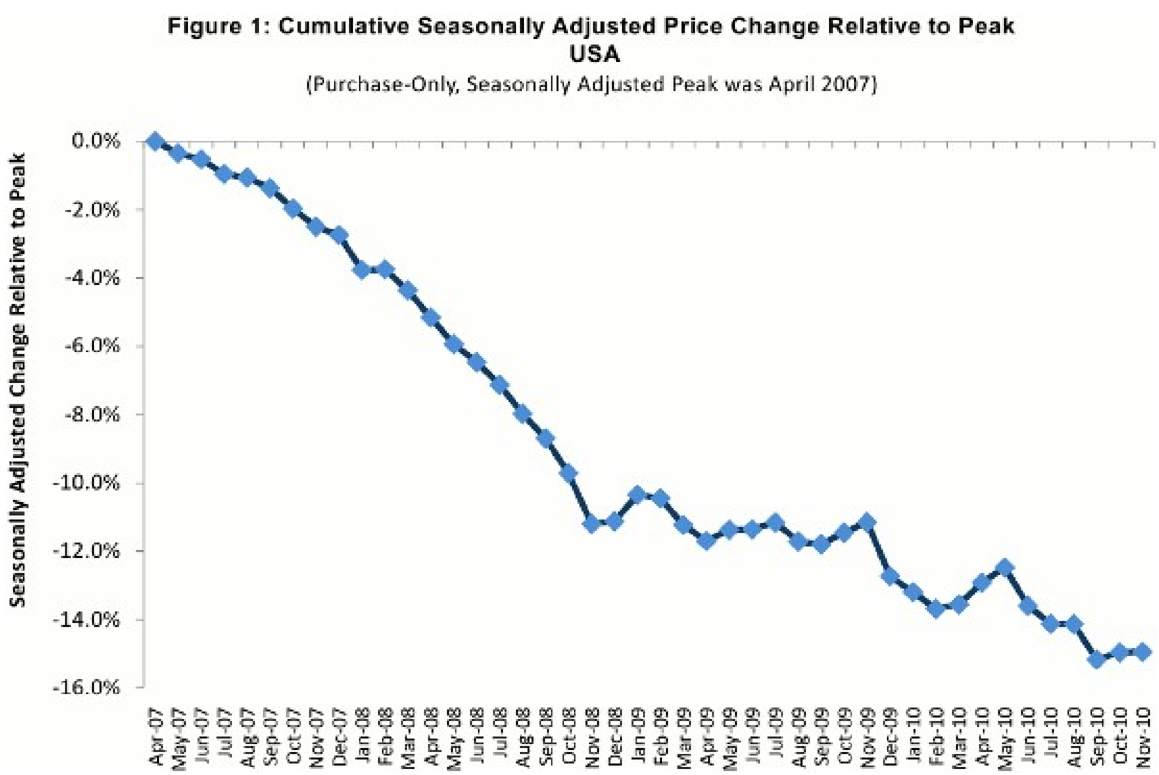
As 2011 begins, The American Investor is faced with conditions in the Real Estate market that present real pitfalls for the unwary, and unique opportunities for the savvy investor. This article briefly outlines some of these pitfalls for investors, and explains how to turn them into opportunities for increased profit.

It seems that no matter where you look today, you will see or hear something about the current crisis in the real estate market. You hear terms like "Housing Bubble", "Record Foreclosures", and "Sub-Prime Crisis". You see stories about the real estate crash, people who owe more than their homes are worth, and banks and mortgage companies being caught in unethical and even illegal practices in the home finance arena. Congress has even become involved by churning out reams of new regulations and laws that directly affect homebuyers - including you, the real estate investor.

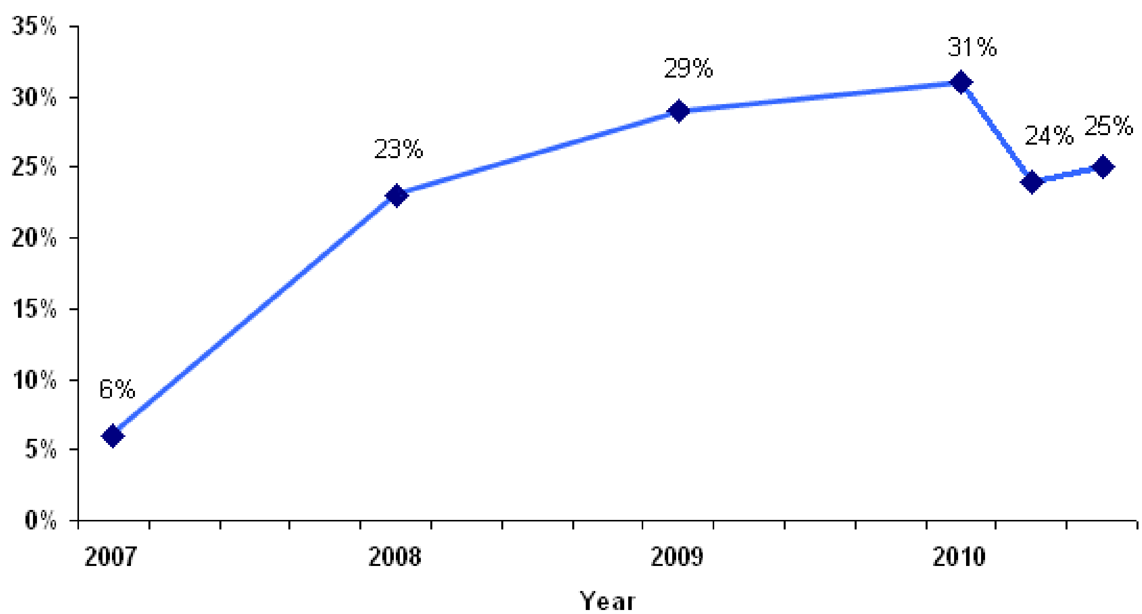
The facts are somewhat alarming at first glance. According to the U.S. Federal Housing Finance Agency (FHFA), Housing Price Index (HPI) has been declining since 2007. The HPI is computed from transactions involving conforming, conventional mortgages on single family properties. The decline in the index is illustrated in Figure 1.



Source: FHFA's Monthly HPI published 1/25/2011.
http://www.fhfa.gov/webfiles/19644/MonthlyHPINov12511.pdf

Another trend that must be considered is the effect of foreclosures. According to RealtyTrac, http://www.realtytrac.com/, 2010 saw a record number of foreclosure filings: nearly 2.9 million, or 2.23% of all U.S. housing units. This number is up from 2.21% of all housing units in 2009, 1.84% in 2008, 1.03% in 2007 and 0.58 % in 2006. Foreclosures accounted for 6% of all residential sales in 2007, 23% in 2008, 29% in 2009, and for the first 3 quarters of 2010, 31%, 24% and 25% respectively. This is shown in Figure 2. The effect of these foreclosures is significant when you consider two things: first, in 2010, foreclosures sold at discounts of 26% to 32% off the prices of comparable non-foreclosed properties; and second, foreclosures are not included in the calculations of the HPI. This means the decline in actual home values is even greater than is reflected by the HPI. To put this in perspective, here at HomeReplay, we are actually buying single family homes for less than what those same homes sold for in the 1980's.

Figure 2 - Foreclosures as a Percent of U.S. Residential Sales



Source: RealtyTrac
http://www.realtytrac.com/

One of the results of falling values that is often overlooked is that it makes it more difficult for sellers to recoup money spent on pre-sale renovations. In fact, according to the Remodeling 2010-11 Cost vs. Value Report (www.costvsvalue.com), out of the approximately thirty types of remodeling projects they track, the only remodel project that *did not* show a decrease in the proportion of value recovered over the previous year was garage door replacement. When you factor in the recent economic downturns, and the increase in unemployment, it is easy to see why more and more sellers are either unable to spend money on renovations, or simply unwilling to gamble their money in what is a soft market for sellers. The net result: these sellers opt to sell their homes "as is".

Also important to remember is the fact that foreclosed properties generally will require more repairs than the average home on the market. This is for a variety of reasons: first, banks are not in the rehab business, and rarely will do much to improve a repossessed property. Second, owners who are being foreclosed on do not typically make repairs to the subject property. Third, I suspect most of us have heard the horror stories of foreclosures where the borrowers either removed or demolished cabinets, fixtures, windows and doors, floor coverings – practically anything in the home can be affected when the borrower decides to prevent the lender from “profiting” from their misfortune. Fourth, foreclosed properties are often vacant for weeks or months, making them prime targets for copper thieves and other vandals.

So, what does this all mean to you, the investor? It means that a substantial number of the residential investment properties on the market today will require some repairs. The cost of these repairs can turn what appears to a good deal into a money pit for the unwary investor. The flip side of this is that the large number of properties with rehab potential presents a great opportunity for the savvy investor. The cost of repairs to a property is an important element of your analysis of a potential investment. Knowing the difference between a winning investment and a loser *requires* that the investor be able to calculate the total cost of the investment. Having an accurate estimate of the repair cost can also assist you in negotiating a lower purchase price.

There are several ways to come up with estimates of repair costs for investment properties. First, if you have a background in the construction trades, or have extensive rehab experience, you can estimate the rehab costs yourself. In this case, you already know what things cost, and you have the confidence of knowing how the estimate is formulated. However, for most investors, and especially those new to real estate investing, this is not normally the case.

Many real estate gurus recommend that investors hire a handyman or contractor to inspect properties before purchase. This is an excellent strategy for new investors, allowing them to take advantage of the experience and knowledge of experts in the rehab field. The question then becomes, how do you find a reliable, knowledgeable contractor? The right contractor is a valuable addition to your team, helping you achieve your investment goals. The wrong contractor will make money himself, but not necessarily help your investing portfolio.

Another method of assessing potential investment properties is to hire a property inspector. Property inspectors are trained to evaluate property, and do perform thorough inspections. The downside of using property inspectors is that they are trained to find anything at all wrong with the property. They have a vested interest in justifying their job. This can lead to ridiculous extremes. For example, on one property we at HomeReplay renovated, a property inspector in the course of his inspection “found” a plumbing leak on the kitchen sink and recommended that a plumber be consulted. The problem? Someone had loosened a slip nut on the drain trap: we tightened it by hand and the problem was fixed without an expensive plumbing service call.

The final method of determining repair costs that we will consider here is where you do it yourself with the assistance of tools specifically designed for the task. There are a wide range of tools available to assist the investor in developing reasonable cost estimates, from courses and weekend bootcamps in property rehab, to books, checklists, and software tools. Training courses are beyond the scope of this article, and books may or may not be up to date and relevant to the current market conditions. Checklists are important in that they help to jog your memory when you walk through a property. The more thorough your inspection, the less chance there is of a costly surprise after you've bought the property. This leaves software tools.

Software tools come in all shapes and sizes. They range from simple spread sheets that merely add up costs entered by the user, to detailed construction estimating software packages that require training courses before you can use them proficiently. The key is to find a tool that is simple enough that it is easy to use and does not require specialized knowledge, and yet is powerful enough to provide accurate and reliable cost estimates.

We first came to this conclusion at HomeReplay over a decade ago. At that time, there were no software tools that fit into that middle ground between the overly complex and the overly simple. Over the last fourteen years we have developed several software tools in-house for our own use. Now, these tools are available to any investor through our website, www.homereplay.com. Investors with computer skills, or who have access to spreadsheet software can still develop their own tools, but if you'd rather spend your time analyzing potential investments instead of re-inventing the wheel, I urge you to check out the tools available to you today. You'll be glad you did.

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