Working with Real Estate Investors: Understanding Investor Strategies

Working with real estate investors can expand your client base and lead to long-term client relationships with investors who buy and sell real estate fair more frequently than traditional clients. The key to developing and sustaining these relationships requires understanding the mindset and needs of investor clients. For instance, investors evaluate properties with a different set of criteria than traditional buyers. Understanding what matters—and what doesn't—can save your investor clients time and money. And speaking of money … financing takes center stage with investors. They're often more aware of their own financing options and actively engaged in determining a property's earning potential. Your role, though, goes beyond just locating and showing properties. You also need to be prepared to jump those negotiation hurdles and meet marketing demands unique to investment properties.

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Course Introduction: Working with Real Estate Investors: Understanding Strategies

By the time you complete this course, you will be able to:

1. Identify common types of real estate investors.

2. Identify investor financing options and how investors determine value and profitability for a property purchase.

3. Recall an agent's role in acquiring and marketing investment properties.

Real Estate **Investor Goals**

Three investment goals

Investors who choose real estate may have goals like preserving capital, making a profit, or finding tax relief.

Profit: Investing in property with an eye toward profit provides the potential for earning income in two different ways from the same investment: rental income and resale value.

Capital preservation: Real estate investment preserves capital because it's considered a hedge against inflation since property values typically rise over time.

Tax shelter: Investing in real estate is a type of tax shelter because the cost of purchasing, maintaining, and operating an income property can be deducted from that income, reducing the amount of taxable income.

Real Estate Investor Strategies & **Property Types**

Types of investors

Investors can be categorized in two ways:

- Property type
- Investment strategy

Investor categories

Investment strategies are the ways in which the investor profits on the investment. These include:

Fix & flip

Fix-and-flip investors need to take their profit and reinvest it in the next deal. They are most interested in immediate resale at market price. When working with flippers, be prepared to work fast and have systems in place that can allow for fast offers.

Flippers must take into consideration not just the cost of purchasing the property but the costs of holding and improving the property.

Buy & hold

Buy-and-hold investors will likely be looking for renters, because they're interested in retaining ownership of the property for a period of time. Buy-and-hold investors are looking for long-term appreciation, passive income, and increased cash flow over time.

Wholesaling

The wholesaler doesn't own investment properties; rather they find deals and resell them (assigns them) to other investors for a fee.

Because wholesalers are essentially middlemen, they need to find seriously discounted deals from very motivated sellers.

Working with
Foreign Real Estate Investors

Understanding foreign investors

Licensees interested in working with foreign investors should get accreditation and training from an association that specializes in foreign investor needs.

Foreign buyers of U.S. real estate

• U.S. urban centers are popular with foreign investors. Factors contributing to this popularity include economic environment, political climate, reputation, and quality of life, and global purchasing power.

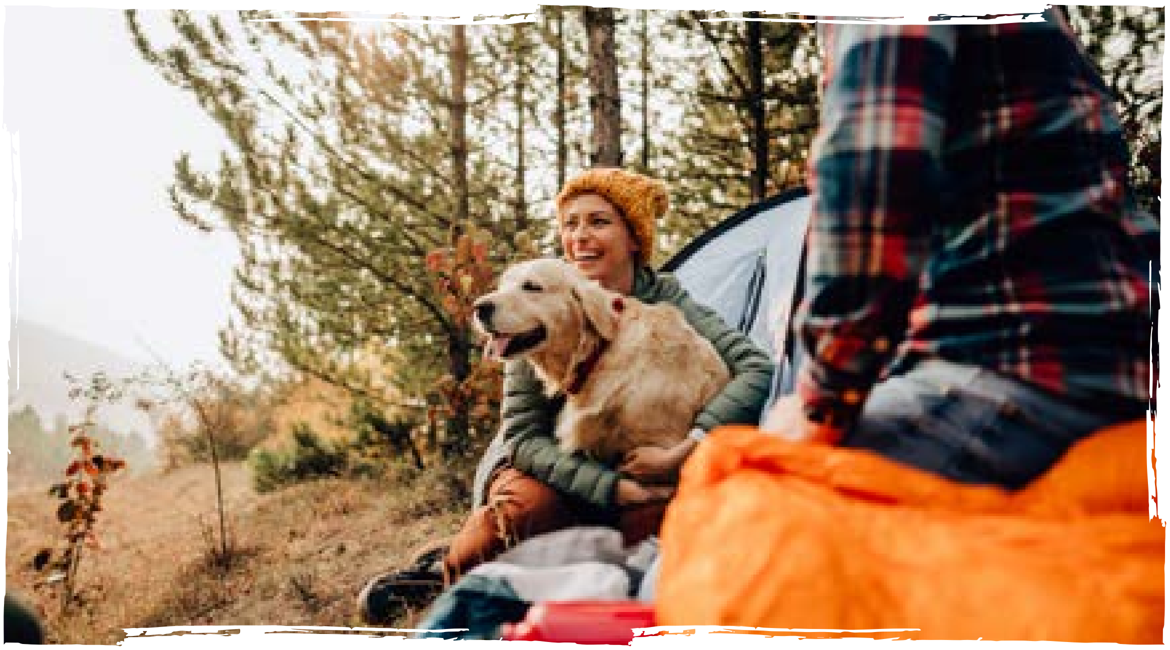
• The high price of real estate in large urban centers is a plus in the minds of foreign investors: one deal can take care of a whole lot of investment dollars that need to be allocated.

• Foreign investors tend to seek out condos and co-ops in urban areas for ease of sale and potential appreciation reasons.

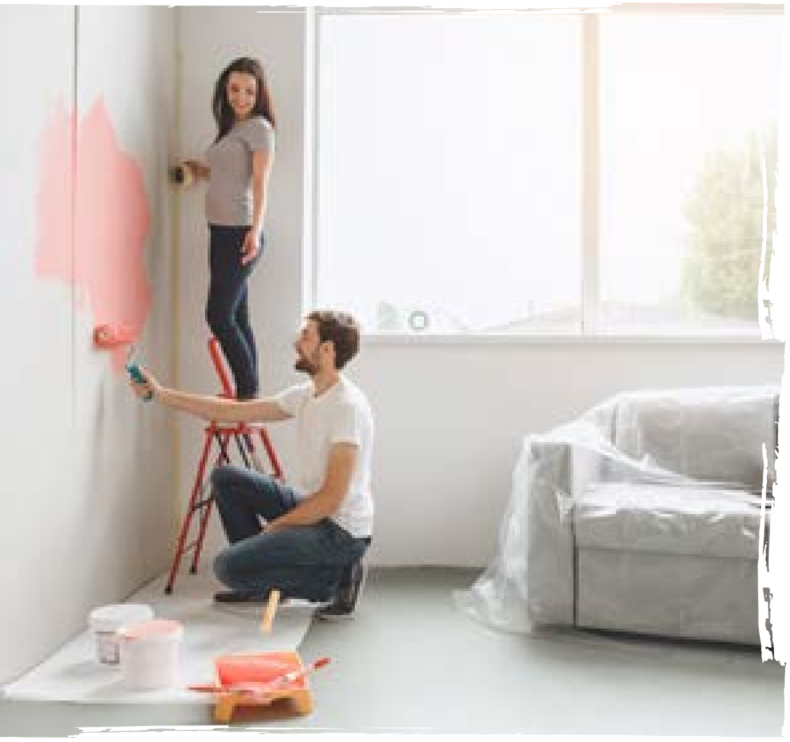
• The Foreign Investment in Real Property Tax Act (FIRPTA) applies to the sale of properties by non-U.S. citizens. It requires a 15% withholding of the sales price at time of sale until applicable taxes are paid.

• Here's how FIRPTA works: When a non-resident sells real property owned in the U.S., the Internal Revenue Service (IRS) wants to make sure it receives any capital gains taxes owed. To ensure this, the buyer must withhold 15% of the gross purchase price of the property when disposing of the property. The buyer then remits the withheld amount to the IRS.

• FIRPTA applies to sale of properties by a "foreign person," defined by FIRPTA as any person who is either not a resident alien (i.e., holder of a green card), or not a U.S. citizen.



Single-Family Homes, Plexes & Multi-Unit Apartments



Investing in single-family detached homes

By investing in a single-family home rental, investors can depreciate an appreciating asset and enjoy having someone else pay the mortgage.

Having to maintain a property, address issues, and collect rent or evict tenants who are behind, are some disadvantages of single-family home rentals.

Other types of single-family investments

Investors in single-family detached homes aren't always thinking about using the properties for rental income. There are many different invest opportunities.

- **Fixer-uppers and older homes**: For those with rehabbing skills, buying a fixer-upper may pay off.
- **Homes targeted for rezoning**: Some investors scout homes on the periphery of commercial zoning. The houses, used as rentals temporarily, can be remodeled after rezoning into office buildings, increasing value.
- **Converting homes to apartments**: Some large older homes in trendy neighborhoods may benefit from a conversion to apartments.

Historic property tax credit

Investors who renovate historic properties can take a tax credit as much as to 20% of the money they spent to renovate the property.

Investing in plexes

The **duplex** is the plex of choice for some investors who are just starting their investment in real estate. They rent out one side, and live in the other. Frequently, investors who start with a duplex move up to larger plexes.

Plexes are named by the number of separate dwelling units. For example, a triplex has three separate units.

Investors can use their live-in duplex as a tax shelter. When the owner "pays" a fair market rent and includes this (plus tenant's rent) in annual income, the entire plex is eligible for allowable tax deductions as income property.

Investing in multi-unit apartment rentals

Multi-unit apartment buildings come in all shapes and sizes; however, anything with more than four units is commercial property. It's considered residential commercial.

Condominiums as a Residential Property Investment

Condo ownership & ownership design

Condominium ownership is ownership of real property. The space inside the unit itself belongs to the owner, as well as a share in ownership of the common elements.

Condo owners enjoy the same tax deductions for mortgage interest and property taxes that other owners of real property do.

Bylaws, governorship & offering plan

Ownership rights and restrictions, and duties of the board and scope of its powers, are detailed in condominium bylaws.

Many times, the board of directors will retain the right of first refusal on units within the condominium development.

The offering plan includes the size of units, construction, floor plans, amenities, recreation facilities, make and model of appliances, windows, how the landscaping of the property will be maintained, and the actual land on which a condominium building is situated.

Condo considerations

Association fees for condos generally cover exterior maintenance, insurance, salaries for building staff, cleaning of common areas, and trash/recycling pick-up.

Financing condos & condominium projects

Developers create and sign a declaration when creating a condominium. This public record describes the property, units, governance, fees, and repair and maintenance responsibilities.

Because condo sales are the first to wane in a down market, and have a higher default rate than single-family detached homes, lenders view them as a slightly higher risk, and therefore require a slightly higher down payment from condo buyers.

Cooperatives as a Residential Property Investment

Cooperative ownership

A cooperative is a joint venture with its shareholders, formed for their benefit and governed by them.

Cooperatives are usually not-for-profit corporations that own the land, building, and all rights and interests of the building. Ownership involves ownership of shares of the corporation and a proprietary lease on one or more units.

Publicly assisted or private cooperatives

Publicly assisted cooperatives (designed for low-income individuals) provide rent and mortgage interest subsidies, as well as two types of low down-payment FHA loans:

- **FHA Section 213**: Provides up to 97% insured financing for certain qualified cooperative projects
- **FHA Section 221(d)(2)**: Provides up to 100% insured financing, designed to meet housing shortage needs

Private corporation vs. private trust co-ops

Most cooperatives are private and are organized as private corporations. They're managed similarly to a corporation, with a board of directors elected from the unit owner/shareholders. Owners are shielded from any personal liability of corporate debts and obligations.

Other co-ops are organized as trusts, where ownership of the property, maintenance, and management is held in a trust company's name. This trust issues participation certificates to buyers of the units. Certificate ownership comes with the right to lease units, subject to co-op rules.

Taxes and co-ops

Buyers into a cooperative don't own real estate, but rather shares in the cooperative corporation. In fact, cooperative owners are actually called shareholders.

Condops

Condops are a hybrid of a condominium and a co-op. Twenty percent of the building is generally commercial, with 80% residential, operating as a cooperative. Condops allow flexibility in selling and subletting.

Commercial Real Estate as **Investment Property**

Commercial vs residential

If the purpose of a property is to generate income, the property is likely commercial.

Some residential properties also generate income, but they aren't considered commercial if they have four or fewer units. Commercial real estate is either non-residential or residential with five or more units.

Local zoning rules determine whether a mixed-use property is considered residential or commercial.

Six primary categories

Commercial real estate is commonly divided into the following six categories:

- Office
- Retail
- Hospitality
- Industrial
- Medical
- Multifamily

Land as commercial property

Land is classified as commercial or residential depending on its use.

Business concerns

A **"going concern"** is a business that has the resources it needs to continue operating into the foreseeable future. If a business is not a going concern, it's either gone bankrupt or is on the verge of bankruptcy.

Going concern value includes the total value of a commercial property plus the business operation.

Real Estate **Investors**

Capital gains & investors

The capital gains exclusion for primary homes (and in some cases, secondary homes) allows some gain to be excluded from taxation. For single taxpayers, the amount of gain that is excluded is $250,000; for married couples filing jointly, it's $500,000.

In order to claim the capital gains exclusion, the taxpayer must have lived in the home for at least two of the preceding five years.

Equity build-up

Equity build-up is a paper gain in the equity in a property over the amount initially contributed toward down payment.

Pyramiding

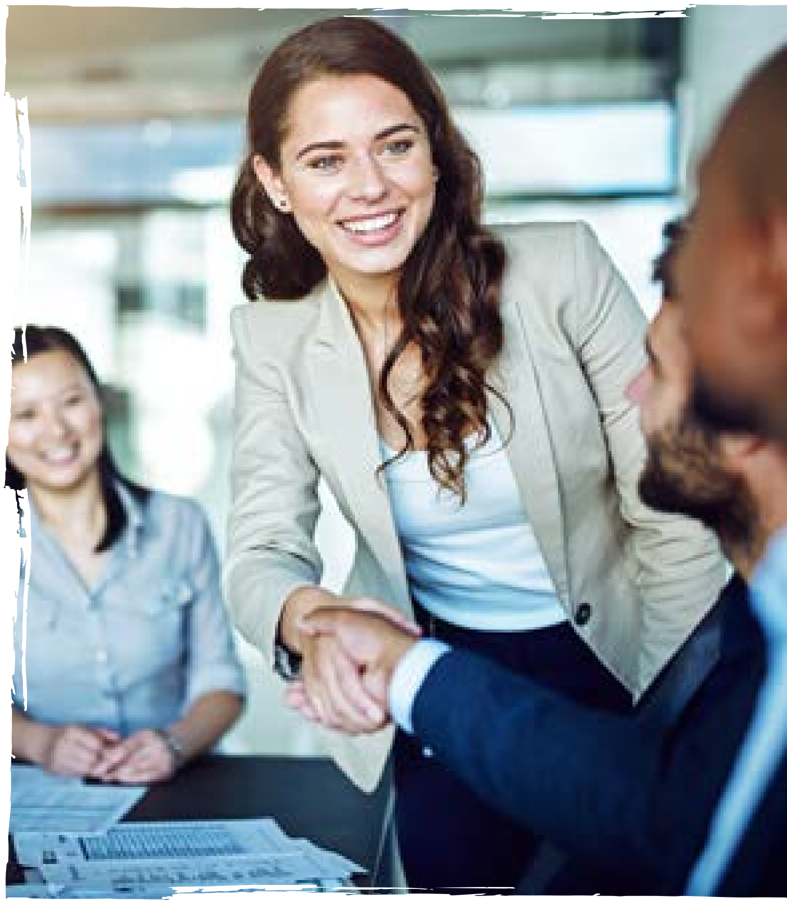
Pyramiding uses one investment property to finance another; this is accomplished through refinance or sale and new purchase.

Investors & the 1031 tax exchange

The 1031 tax-deferred exchange allows investors to defer capital gains taxes when selling a property provided the money is rolled into another "like" purchase.

Investors will have to pay capital gains taxes unless they roll those gains into a new investment property and use the 1031 tax-deferred exchange process to do so.

A 1031 tax-deferred exchange involves the following deadlines:



- Subsequent property identification within 45 days of sale of the relinquished property
- Closing on the subsequent property within 180 days from the closing date on the relinquished property

The 1031 exchange is similar to rolling over retirement funds the investor rolls over the capital gains from the sale of one property into the purchase price of the next property, deferring (but not avoiding) taxes on that gain.

Investors would be most interested in the tax-deferred benefits realized from a 1031 tax exchange.

Real Estate Investors, Income & **Cap Rates**

Analysis of investment properties

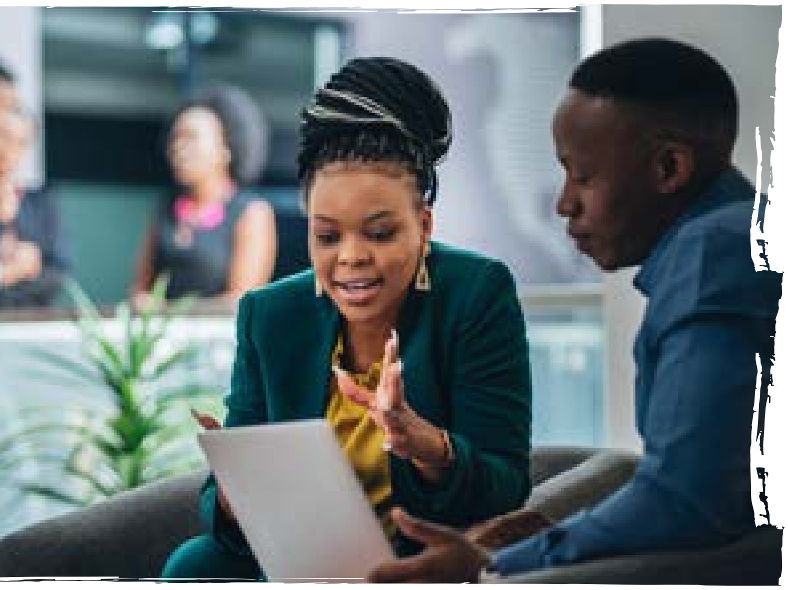
To ensure they're making a good investment, investors need to determine the approximate value of the income-producing property they're interested in acquiring.

Fixed and operating expenses

All expenses relating to the operation of the investment property are deductible expenses. Examples include:

- Maintenance
- Utilities
- Supplies
- Advertising
- Legal/accounting
- Wages and salaries
- Property management

It's also necessary to take into account fixed expenses such as insurance, taxes, and licenses and permits.



Gross income

Gross income is the income received before the operating expenses are deducted.

Potential gross income is income that a property could bring in if leased at full capacity. Once from vacancies and credit losses are deducted from potential gross income, you get effective gross income.

Net operating income

Once you deduct operating expenses from effective gross income, you get net operating income.

Investors may also be able to apply allowable interest deductions from their mortgage payments. Mortgage principal and interest payments are called debt service.

When you apply interest deductions to net operating income, you arrive at net taxable income.

Capitalization rates

Capitalization rate is the return on investment that other investors in a given market receive for a similar property.

The factors in the formulas are generally referred to as "I" for income, "R" for rate or cap rate, and "V" for value.

To determine income: Multiply cap rate by value (R × V = I)

To determine value: Divide income by rate (I ÷ R = V)

To determine rate (cap rate): Divide income by value (I ÷ V = R)

Appreciation & **Depreciation**

About appreciation & depreciation

Understanding how a property might increase or decrease in value plays a role in selecting investments.

Appreciation

Ideally, when you purchase a property, its value will increase over time. This is called appreciation. You can find the appreciated property value by taking the original value and multiplying it by the appreciation rate.

Depreciation

Depreciation is defined as an asset's reduction in value.

- Tax depreciation is a theoretical loss in value over time as a result of typical wear and tear. It's used to calculate a business deduction based on an assumption that property has a limited service life.
- Economic depreciation is an actual loss in value, often from external factors (such as the economy).

Depreciation limitations

Depreciation is limited to investment properties (you can't depreciate residential, non-investment properties).

Basis

The **basis** of an asset includes the sale price, acquisition costs, and any capital improvements (such as renovations or additions).

Tax depreciation is good for investors

Investors like tax depreciation for a couple of reasons:

- **It's a form of cost recovery.** The investor recovers the cost over the asset's life through tax deductions.
- **It allows investors to shelter some of their earned investment income.** Not only is the property appreciating in value, and not only are tenants paying the mortgage in lease payments, but the investor also gets to offset some of that income by depreciating the value of the property over time.

The IRS requires investors to depreciate their investment properties, which is called straight-line depreciation.

Income-producing residential properties are depreciated on a 27.5-year schedule; commercial properties are depreciated over 39 years.

Formula for calculating the basis

Sales price + acquisition costs + capital improvements = basis

Formula for straight-line depreciation

Basis ÷ recovery period = allowed annual tax deduction

Cash Flow, Financing Options & **Real Estate Investors**

Cash flow is king

Investors are looking at before- and after-tax cash flows, sheltering cash from taxes, and cash-on-cash return.

Before-tax cash flow

For **before-tax cash flow**, you take income and subtract expenses and debt service. The before-tax cash flow is calculated before income taxes are figured in.

Cash-on-cash return is a ratio or percentage of the before-tax cash flow divided by the cash invested. Cash-on-cash also doesn't account for appreciation or depreciation of the property.

After-tax cash flow

After-tax cash flow is the cash flow after income taxes are deducted. To determine after-tax cash flow, take the profit yielded from the investment and subtract income taxes that apply to the property's income.

A paper loss of negative after-tax cash flow can be used as a tax shelter. This is desirable by some investors because shelters can be used to offset other income.

Conventional loans

Investors usually seek out non-conventional financing after the first deal because conventional financing has debt-to-income requirements that can trip investors up.

Federal Housing Administration loans

FHA loans are only available for owner-occupied homes. Lying about anything (including occupancy) on mortgage loan documents is mortgage fraud.

Portfolio loans

Portfolio loans are funded in-house and usually offered by smaller lenders who have more flexible standards.

Commercial loans

Commercial loans have higher rates, shorter terms, and balloon payments, compared to residential loans.

Working with Investor Clients & Locating Investment Properties

Pros & cons of working with investors

Investors buy more than once: Investors may buy and sell multiple properties in a year. Investor clients can also be a great way to generate referrals.

Transactions have certain advantages: Many investors are seasoned home buyers and sellers, they know what to expect; meaning smooth contracts and closings.

Experience counts: New investors may need more attention and hand-holding than some of your traditional clients, as they're essentially getting training in the field.

Work schedule: A challenge in working with investor clients is that they may expect you to spend a lot of time writing lowball offers that may never end in sales.

Finding investment properties

Licensees working with investors should foster relationships with title companies, real estate agents who work with investors, trustees and bankruptcy agents, divorce and probate attorneys, and real estate investment groups to find leads on properties.

Listings in the MLS that say "subject to court approval" likely means a bankruptcy and possibly a low sales price.

Auctions

Consider builder, tax, and foreclosure auctions. Bargains can be found in the right locations, and some properties can be bought for hundreds, not thousands, of dollars.

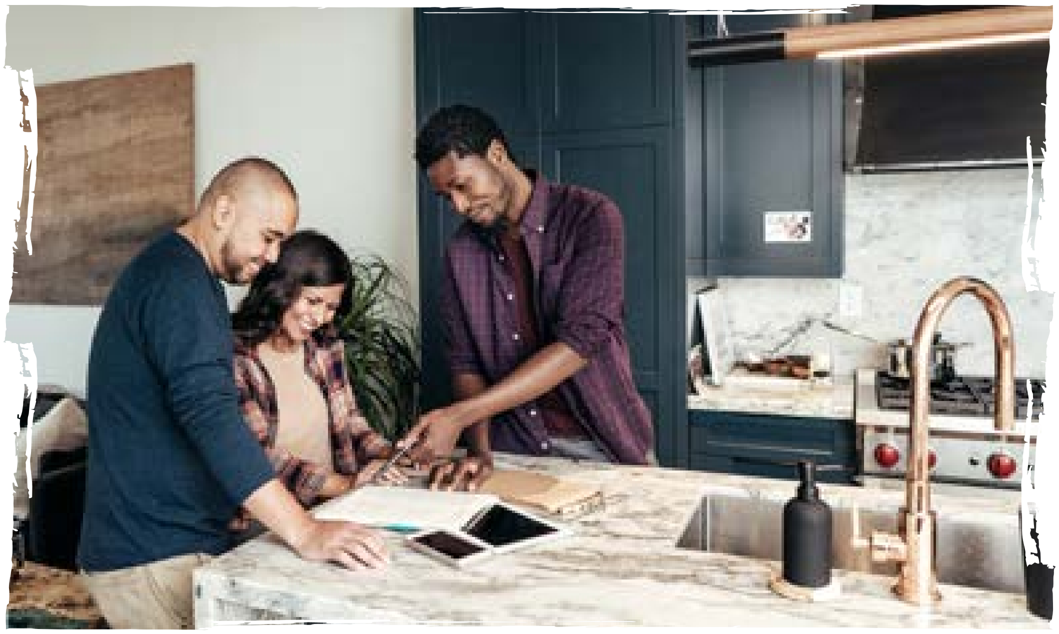
Execution & sheriff's sales

Sheriff's sales are for savvy investors with a bankroll, but bargains can be had.

Probate houses

Sometimes, heirs to a property have endured a long probate process and aim to liquidate a property quickly.

Negotiations & Strategies for **Working with Investors**



Negotiation: Getting the deal

Sellers are interested in the best price and most favorable terms.

To soften the blow of a low-ball offer, investors will often try to sweeten the deal. They may do this by waiving appraisals and inspections, offering to pay cash, or offering to close quick.

Paying cash for a property allows the transaction to close quickly and is usually motivating to the seller.

A reasonable expiration date ensures that the deal doesn't drag on.

Marketing strategies

How you market an investment property depends in large part on the property type and investment type. Keep your clients informed about the marketing tools and techniques you're using.

Networking can be an effective marketing tool, in particular face-to-face, phone, email, and text communications with other licensees.

Marketing various property types

Fix-and-flip investors need to take their profit and reinvest it in the next deal. They are most interested in immediate resale at market price.

Buy-and-hold investors will be looking for renters, because they're interested in retaining ownership of the property for a period of time.

Commercial property investors are most interested in cash flow analysis and projections. Some marketing tactics for selling commercial properties include print ads, staging, For Sale signs, and networking.

Ethical Duties When
Working with Investors

NAR Code of Ethics

The NAR Code of Ethics was first adopted in 1913 to outline the behaviors and actions that are expected of REALTORS® and to protect consumers. The NAR Code of Ethics is based on the Golden Rule and is a living document that is constantly evolving.

All REALTORS® must adhere to the code, whether they're working with investors or traditional homebuyers.

The Code of Ethics & investor clients

Article 10 requires equal professional services to all parties, regardless of race, color, religion, sex, handicap, familial status, national origin, sexual orientation, or gender identity.

Article 11 prohibits REALTORS® from providing specialized professional services outside their areas of expertise. It permits a REALTOR® to assist clients with real estate transactions only.

Real estate investor associations

Many real estate investors belong to trade associations like the National Real Estate Investor Association (National REIA) and/or other local associations.