SHORT-TERM RENTAL LONG-TERM WEALTH

Your Guide to Analyzing, Buying, and Managing Vacation Properties

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Chapter 2

CHOOSING THE RIGHT MARKET FOR YOU

Perfectionism kills every dream—better to just start.

—MIKE MICHALOWICZ, IN "PROFIT FIRST"

Short-term rentals, or vacation rentals, are a relatively new strategy when it comes to real estate investing. Although vacation rentals have been around for decades, it wasn't until the inception of Vrbo and Airbnb that traditional real estate investors began to invest more widely in them. If you're reading this book, chances are you want to explore the ins and outs of this strategy, but you aren't sure where to start.

The first thing you'll need to do is choose the type of market in which you want to invest. You'll begin by researching and analyzing factors like the average occupancy rate, price per night, and cost of properties in the

area you're evaluating to determine whether an investment makes sense.

You've probably heard an anecdote or two from a friend who bought a house in the downtown area of their city and "is making a killing" on renting to conference-goers, traveling sports fans, and business travelers. "We're getting $500 a night," they might say. However, when probed, they cannot answer questions about things like occupancy rate, gross annual income, and expenses. A rate of $500 per night sounds great, but how many nights a year is the property booked? What is the monthly mortgage payment? How much do electricity and internet cost? Are there HOA fees? Does the $500 a night cover all expenses?

A random strategy yields random results. As a serious investor, you must do the proper research to choose the best market in which to invest based on data and historical information. Don't just buy a place close to Wrigley Field that will "pay for itself" because you're a giant Cubs fan.

THREE TYPES OF STR MARKETS

There are three core types of STR markets: metro markets, national fly-to vacation markets, and regional drive-to vacation and leisure markets. There is no right or wrong type of market for investing in STRs. However, all markets come with varying degrees of stability or volatility, based on a number of attributes. Each type has its pros and cons, which I will detail in this chapter.

Your choice of market will depend on what your goals are and how comfortable you are with risk. For example, I prefer the income and regulatory stability of the regional, drivable vacation rental market, although I know plenty of people who earn great returns from investing in metro markets, which are much riskier and have trickier STR regulations. Whichever type of market you choose, make sure you do the research before diving in.

Metro Markets

Metro markets are major metropolitan areas that attract many visitors but are not financially dependent on tourism. They have jobs and industries that support their local economies, and they usually have large and dense permanent-resident populations. Examples include New York, Los Angeles, Austin, and Nashville.

In metro markets, short-term rentals are a relatively new choice for

renters who historically would have stayed in a hotel. These types of renters include professionals on business trips, traveling medical professionals, and locals taking "staycations." A significant pro of metro markets is this diverse pool of guests, as it offers a broad spectrum from which to obtain renters.

The inception of Vrbo and Airbnb presented quite the opportunity for early adopters of STRs in major metro markets, like my friend in Brooklyn. Their product was new and provided more space and comfort than standard hotel accommodations. Plus, at the time, such accommodations were scarce in their markets.

While metro markets have extremely high rewards in terms of cash flow, they are arguably the riskiest type of STR market, based on several factors. The historical preference for hotel rooms over privately owned homes, coupled with a dense permanent-resident population, has proven troublesome for many metro markets over the past decade. Additionally, metro markets have a far more volatile STR regulation structure than other types of markets. I know many metro-market STR investors who were shut down after a few short years of operation.

There are three main economic drivers of anti-STR regulations in major metropolitan areas:

1. **Hotel lobbyists:** Lobbying funded by major hotel chains is the largest source of anti-STR regulations in metro markets across the country. As hundreds of STRs have flooded the hospitality market and gained significant market share, hotels have made no small effort to eradicate them. By having lobbyists work to get bills introduced at the local level, the hotel chains have successfully curtailed the growth of the industry. This has resulted in cities' limiting the zones in which STRs are allowed, revoking permits, and, in some cases, banning them altogether.
2. **Disgruntled neighbors:** As STR investing has become more popular in many cities, properties on previously quiet residential streets have been converted into "mini hotels" and "party houses." Their permanent-resident neighbors have taken to city councils to voice their contempt for the perceived negative effects that STR investors have had on their neighborhoods. Negative local media coverage of these grievances and the few incidents that have caused them have created an adversarial relationship between STR owners and non-investor permanent residents.

3. **Lack of affordable housing due to Airbnb investors:** As long-term rental or primary-home properties have been acquired, renovated, and converted into STRs, property values in many metro markets have skyrocketed. Since it can be difficult to acquire these properties in major cities, they are often sold at a premium, and those premium-priced sales have caused rapid appreciation in the surrounding areas. While this sounds like a positive to investors, it has caused a severe affordable-housing issue for permanent residents in some markets, once again sending advocacy groups and locals to city councils with their complaints.

Another key consideration when investing in metro-market STRs is market saturation. In the rare metro market where STRs are largely unregulated, this is a very real possibility. When a market has gone from very few of these rentals to many over the course of a few years, and additional properties are being converted into STRs almost daily, market saturation is on the horizon. Of course, you always have the option of converting the property into a long- or medium-term rental if needed.

National Vacation Markets

National vacation markets are tourism-dependent. Think big, popular vacation markets that most travelers access by plane, such as Honolulu, Hawaii; Aspen, Colorado; and Orlando, Florida.

These markets are stable in terms of rental regulations because STRs have been part of the economic fabric for decades. Still, affluent permanent residents and large resort chains have pushed for STRs to be allowed only in certain areas. For example, Hawaii and Jackson Hole, Wyoming have strict regulations to keep their permanent residents happy. In fact, there are fewer than ten neighborhoods in Jackson Hole where short-term renting is allowed. This makes it difficult to find properties that are properly zoned to allow short-term renting and self-management of STRs.

While national vacation rental markets are quite lucrative during economic booms, they are the first to see a downward trend in a recession. As travelers tighten their purse strings, lavish fly-to vacations are traded for more affordable, closer-to-home destinations.

Regional Vacation Markets

In regional vacations markets, the majority of tourists arrive by car.

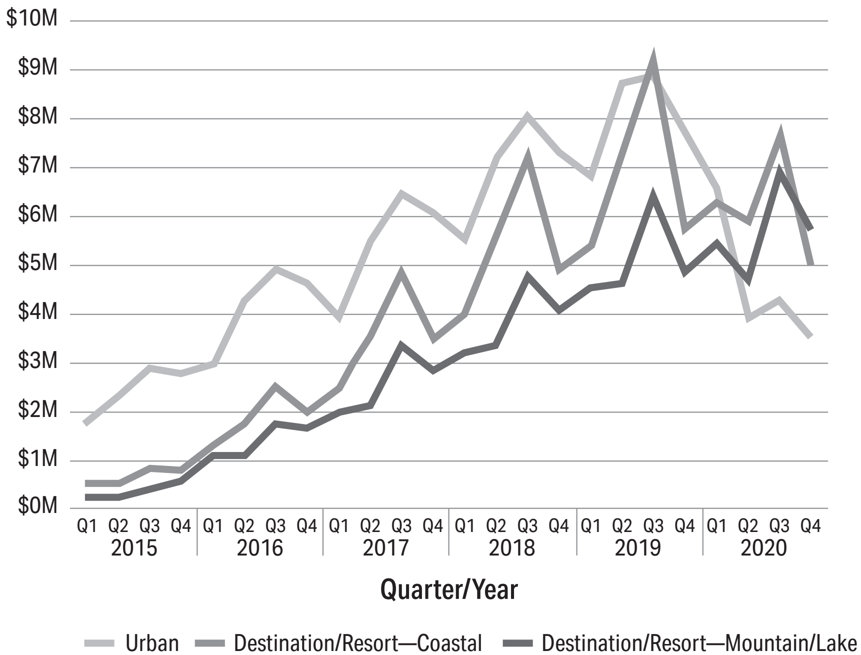
Examples include Gatlinburg, Tennessee; Panama City Beach, Florida; Big Bear Lake, California; and Branson, Missouri.

Regional leisure destinations are 100 percent financially dependent on tourism and have been for decades, just like the national vacation markets mentioned previously. There is little or no industry outside of tourism in these areas. However, one major difference from the national markets is that regional markets are much more affordable and more easily accessible.

Since these markets are often smaller towns, real estate prices tend to be cheaper than those found in national vacation rental markets. Additionally, many of these markets boast fewer permanent residents and more vacation renters, many of whom have been renting privately owned cabins, condos, and single-family homes rather than hotels since well before the inception of sites like Airbnb.

STR regulations are very accommodating in these markets, since local governments determined how to monetize STR income decades ago. City council clashes are therefore nonexistent. As a matter of fact, the small occupancy tax collected by these governments is so lucrative that it would be far too fiscally detrimental for them to regulate STRs.

On the surface, it would seem that metro markets are the best for STRs given their diverse pool of travelers. However, because of regulation issues in most metro areas, it's actually the regional, drivable vacation rental market that is the most stable investment. Regional markets are the most recession-resistant due to affordability and accessibility, which we will address in later pages.



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TOURISM AND RECESSION RESISTANCE

STRs are dependent on the tourism and travel industry, so it is important to ensure that there will be enough travelers for an STR to be profitable, even during economic downturns. Several factors contribute to market resilience.

First, we will take a look at the drivers of the past two economic downturns: the housing/financial crisis of 2008 and the COVID-19 pandemic of 2020–2021. During both of these economic downturns, the regional vacation market performed better than the metro and national vacation markets. That was thanks to its two pillars of recession resistance: affordability and accessibility.

1. **Affordability:** In the Great Recession of 2008, the disposable income of the average American family dropped dramatically. Many potential STR investors mistakenly assume that everyone stops going

on vacation when they have less disposable income. This is simply not the case. Travelers may no longer take a trip to Aspen, Disney World, or Hawaii, but they will still go on vacation—albeit to a more affordable vacation destination that does not require flights or expensive ski lift and theme park tickets. In other words, families go on local weekend getaways in a recession.

2. **Accessibility:** At the beginning of the COVID-19 pandemic in 2020, all STR markets took a forceful hit, but as reopenings started across the country, regional leisure markets outperformed both metro and national vacation markets. This time, while affordability was most definitely a factor, accessibility was the main driver of success.

After months of lockdowns, the entire population was bursting at the seams to get out of their homes. However, most Americans were not comfortable traveling to big metro areas with large concentrations of people, and they were even less comfortable with boarding flights and being confined with strangers for even a short period of time. Due to the fear of contracting the virus, travelers drove to their nearest vacation destination, in the comfort of their own vehicles, to rent single-family residences where they could be outside and enjoy themselves at a safe distance from other people.

DISCOVERING A MARKET'S INCOME POTENTIAL

When you have found an STR market that interests you, the first thing you need to do is examine the STR regulations in that market. You would be surprised at how many investors do not look into this before shopping for a property.

There are three levels of market strictness when it comes to STR permits: stringent, medium, and relaxed.

Stringent Markets

Stringent markets are those in which a battle is constantly being waged between STR owners and the city council. It's difficult to obtain a permit in these markets because of arduous, ever-changing processes and rules. Investors must monitor city council meetings closely, as anti-STR bills are passed often.

An example of a stringent market is Nashville. Clients call me on

a weekly basis saying, "I am prequalified for up to $1 million. I found this $950,000 property that I'm in love with. Let's make an offer." More often than not, I have to dash their rhinestone-studded, guitar-pickin' dreams by breaking the news to them that their honky-tonk investment is not zoned for STRs. Even if a property *is* currently zoned for STRs, that doesn't mean it will be in the future.

Nashville is a city that experiences brutal clashes between city council members and STR owners. Each quarter, a new bill is introduced to the city council to shrink the geographic area where STRs are allowed, to limit the number of permits, or to cull the number of existing STRs altogether.

I had a situation recently where a developer began a project that consisted of fourteen purpose-built STR townhome units in the correct zoning. This property was in an ideal location: walkable to dining, shopping, and nightlife. Several of my clients purchased units in the pre-construction phase after having completed all necessary due diligence on zoning and income, and the papers were signed. Completion was scheduled for the following year. Six months into the contract, the city council passed a bill changing the zoning of this property to prohibit short-term rentals. The move would cause investors in this development, as well as several other developments across the city, to no longer be able to use the property as they had intended. None of the developers were allowing investors to withdraw their contracts without lawsuits either. It was a giant mess. Eventually, an agreement was reached that allowed the grandfathering of permits to be extended to developments that had broken ground within the past year, but the amount of stress and mental anguish these investors went through was not worth the investment.

The lesson here is that while stringent markets can be extremely lucrative, their ever-changing regulations need to be monitored constantly, which can be a full-time job in and of itself. The entire idea behind real estate investing is to generate passive income, so investors really have to weigh whether the income potential is worth the headache of keeping up with regulations in this type of market.

Moderate Markets

Moderate markets feature regulations that are stable and manageable for both STR owners and primary residents. These markets are very friendly toward STRs, as long as they are operated only where allowed by local zoning laws and with the correct permits.

Destin, Florida, where I own a property, is an example of a moderate market. There are clear boundaries designating where you can and cannot operate STRs. The main rule is that the city does not allow any STRs to be operated north of Highway 98, in order to preserve affordable and quiet housing for the few people who actually live in that market full-time. The beach and most main tourist attractions are south of Highway 98, so having an STR north of the highway wouldn't be ideal anyway.

To operate an STR in this market, I had to get a business license with the Florida Department of Revenue and an STR license with the city of Destin. An inspector had to approve the driveway for the number of parking spaces I can advertise, and a sign outside my property must state certain contact information. If I get too many tickets for violations like not pulling my trash cans in or having too many cars in the driveway, I can have my vacation rental license revoked.

Properties in moderate markets are great long-term investments as long as you don't skirt any rules on the front end and you pay your STR occupancy taxes, which we will discuss in a later chapter.

Relaxed Markets

Let me start this section by screaming from the rooftops that "relaxed" does not mean "free-for-all." Relaxed markets still have rules and regulations, but they are minimal, and revocation of STR licenses is typically unheard-of.

A great example of a relaxed market is the Great Smoky Mountains of East Tennessee. There are just two small geographical zonings within the cities of Pigeon Forge and Gatlinburg that do not allow STRs in order to preserve some housing for the locals.

Permits are usually required, but it shouldn't take more than a quick phone call to the county office to obtain one. These markets typically have as many (or more) STRs as they do permanent residences. The cities and counties are so dependent upon the local occupancy tax income from STRs that it's in their best interests to keep the regulations relaxed to make things easy for investors.

MARKET MATURITY

The second item to evaluate when choosing a market is its maturity. How long have STRs been the norm for travelers rather than hotels? How