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THE BOOK ON FLIPPING HOUSES

How to Buy, Rehab, and Resell Residential Properties

J SCOTT

REVISED EDITION

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THE BOOK ON FLIPPING HOUSES

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THE BOOK ON
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CHAPTER 5
WHAT YOU SHOULD BUY

One of the hallmarks of a successful investor is good time management, and when it comes to investing, one key to time management is knowing what kinds of properties you should be focusing your energy on and what kinds of properties are just a waste of your time. While any property can be a potential deal if you're persistent enough (and skillful enough), new investors should be focusing their time and energy on the types of properties that are most likely to result in successful acquisitions and great deals.

Distressed Properties

The key to being a successful real estate investor is being able to target and find distressed properties. You'll often hear that term in this business, and you'll hear it used in many different contexts. But generally speaking, a distressed property is one where either the owners of the property or the property itself are in a position where it is likely that the property will sell below market value.

Conditions Leading to Property Distress

There are typically three situations that will cause a property to be distressed, and will in turn lead to a property being sold below market value:

1. **Financial Distress of Owners**
    - By far the most common situation that results in property distress is the adverse financial situation of the owners. There are

two common financial situations that lead to the bulk of distressed properties:
    - Homes are "underwater" on their mortgages. In other words, owners owe more on their mortgage than their house is worth. This means that the homeowner either needs to sell for less than what they owe, or they need to find a creative solution where they can sell the property (or transfer control of the property) without having to pay off their loan at the time of the sale.
    - Homeowners are having trouble making their mortgage payments. Even in situations where a home isn't underwater, if the homeowner is having trouble making their mortgage payments—due to loss of their job, underemployment, etc.—they will find themselves at risk of foreclosure if they can't sell their property quickly. This often leads to discounts on the sale of the property, especially if the buyer can close quickly without requiring much from the owner in terms of financial help.
  - Whether a homeowner faces one or both of the above financial situations, there is an opportunity for the smart investor to help solve the homeowner's problems, and in return get a great deal on a house.

2. **Personal Distress of Owners**
  - Owner distress isn't always caused by financial situations. In many cases, the distress of the homeowner can be caused purely by life circumstances out of their control. Sometimes common life situations will require a homeowner to want or need to sell their house quickly, and when owners are put in a position where they are forced to sell quickly, they will generally be willing to sell at a discount to make that happen.
  - The four most common situations you'll run into where a homeowner wants or needs to sell their house quickly are as follows:
    - Divorce of the owners.
    - Death of one or more owner.
    - Job change requiring a quick relocation.
    - Tired and overworked landlord.
  - These circumstances often translate into a situation where the seller is extra motivated to get rid of the property quickly, creating a great opportunity for a savvy investor.

3. **Poor Property Condition**
   - In many cases, the distress is more related to the condition of the property than to the circumstances of the owner. When a property is in poor condition, the potential set of buyers for the property is reduced. Typical homeowners don't want to buy a house where they will need to do a lot of work and spend a lot of money, even if it means the house can be purchased at a discount. They'd rather spend more money for a house where they can just move in and not have to deal with property issues.
   - In fact, even if a typical homeowner were willing to buy a property in poor condition, their lender probably wouldn't allow it. Most traditional mortgage lenders will not lend money to buyers for properties that aren't in move-in-ready condition, meaning all the major systems in the house work. Even little stuff like a non-functioning water heater or missing stove can be enough for a lender to refuse to provide a mortgage.
   - Properties in distressed condition may just need basic updating or they may need a huge overhaul, but what they have in common is less competition from retail buyers. In some cases, where the houses need a lot of work, there is even less competition from other investors who are scared of big renovations. These situations provide great opportunities for investors who are unafraid to jump in and get their feet wet.

As an investor, you should think of yourself as a problem solver; one of your biggest keys to success will be finding problems and then figuring out creative solutions. If you can find homeowners who are facing the situations we discussed above, and if you can position yourself to help solve their problems in a way that is a win-win for both sides, you'll find that great deals are constantly falling into your lap.

Retail Properties

I want to quickly touch on the opposite of distressed properties—retail properties. I know of many new investors who, even after being told time and again that they should focus on distressed properties, instead spend their days looking at and making offers on retail properties. They get discouraged as offer after offer is ignored or rejected. As an investor, it's important that you know the difference between a retail and a distressed property, and also that you understand why you should be focusing your time and energy on distressed properties and not retail properties.

"Retail" simply means that the sellers and the property are not distressed, and that the property is in good enough shape that it would likely sell to a homeowner who will move into the house. Retail properties are the most common type of property that you'll encounter as a real estate investor; they are everywhere, which is why they are such an allure for so many new investors.

However, you don't want to get caught up in the trap of thinking, "If there are so many retail properties out there, it shouldn't be too hard for me to find a few bargains to buy and resell." There are several reasons why retail properties are nearly impossible for investors to buy at a discount and why investors generally shouldn't bother focusing on them:

- Retail properties are by definition in good condition, and there is going to be a lot more competition for these houses than for other houses in worse condition. The reason for this is simple: Houses in good condition require less work from their buyers and are much easier to get mortgages for.
- Retail properties have a large buyer pool, and because the sellers aren't desperate to sell, it is often very difficult to buy these properties for less than market value, which means there's almost never much financial room to buy a retail property, add value to it by fixing it up, and resell it. For this reason, fewer investors will spend much time looking at or considering purchasing retail properties.
- Retail properties are generally marketed very widely. Often, they are listed on the MLS and other real estate websites for everyone to see, which means that you will have no competitive advantage over other buyers looking for a property.

So, now that I've hopefully convinced you that distressed property is the key to successful investing, it should also be obvious that the more distressed the property or the more distressed the homeowner situation, the better the opportunity for a great deal.

With that in mind, I want to talk a bit about the foreclosure process. In many markets and at many times, foreclosed properties are an excellent way to acquire good deals; in fact, many investors build their entire real estate business around buying foreclosures.

Keep in mind that there are several phases of the foreclosure process, and the further along in the foreclosure process a property is, the more distressed the homeowner, or the bank, is likely to be.

The Foreclosure Process

First, let's define—in very simple terms—what foreclosure is:

> Foreclosure is the legal process whereby the lender on a property can gain ownership of the property should the borrower default (stop paying) on the loan. When a homeowner cannot pay the monthly mortgage on his property, the lender (generally a bank) can gain control and ownership of the property. The lender will usually attempt to sell the property at auction in attempt to recoup the loan amount, and if that fails, will often sell the property using a real estate agent and the MLS.

Depending on which state you live in, you will see one of two sets of processes around foreclosures:

- **Non-judicial foreclosure:** This is a foreclosure process that doesn't involve the courts or the judicial system and where the rules for foreclosure are defined by state statutes.
- **Judicial foreclosure:** This is a foreclosure process that is processed through the court system, much like any other type of lawsuit.

Many states support both types of foreclosure process, though one or the other will typically be the standard.

Non-Judicial Foreclosure Process

In most non-judicial foreclosure states, in order for a property to be foreclosed upon, the lender must go through a several-month process to regain control of the property and then sell it. While every state has their own particular set of rules to be followed, the timeline below indicates the most common high-level process of non-judicial foreclosure:

NOTICE OF DEFAULT

The first step in the foreclosure process is the filing of a "notice of default" (NOD) with the county recording office in the county where the property is located. This happens after the borrower misses several months of payments. This puts the homeowner on notice that the foreclosure process has begun and that the house will be scheduled for auction or sale.

NOTICE OF TRUSTEES SALE

If the borrower doesn't bring the loan current within a set period of time after the NOD is filed, the lender will post a notice of sale on the property. This notice will also be recorded with the county recording office and will typically be published in a local newspaper or publication over the next several weeks.

TRUSTEES SALE

At the time and location specified on the notice of sale (usually on the county courthouse steps or at the property itself), the property is auctioned off to the highest bidder, who must pay the high bid price in cash. The winner of the auction receives ownership of the property.

The opening auction bid on the property is made by the foreclosing lender, and this opening bid is usually equal to whatever amount was owed on the property by the borrower, plus any accrued fees. But most properties aren't deemed by most investors to be worth the amount owed, so the majority of properties don't receive a bid at or above the opening bid price. And, if there are no bids higher than the opening bid price, the property will be purchased by the lender.

REAL ESTATE OWNED (REO)

Properties that don't sell at auction and are purchased by the lender are called "real estate owned," or REO, properties. These properties are then sold by the lender almost exactly the same way as any other property sold on the open market. At some point after the trustee's sale, the lender will put the REO property up for sale by listing it with a real estate agent on the MLS. The amount of time that a lender will wait before listing the property for sale on the MLS varies based on the whim of the lender. A lender may put an REO property up for sale within a couple weeks or may hold onto the property for months or even years before listing it for sale. This is why so many houses that look foreclosed may sit vacant for months or years before you notice a "for sale" sign in the yard.

In some states, this entire process can be as short as just three to five weeks, and in other states could be as long as one to two years. Additionally, some jurisdictions will auction off property as little as once per month, while other jurisdictions may hold auctions every day of the week. You'll want to get familiar with your state's laws if you're buying in a non-judicial foreclosure state.

Judicial Foreclosure Process

Because the judicial foreclosure process is complicated and will be controlled by lawyers and the court system, these types of foreclosures are beyond the scope of this book. But, you should note that once the process is complete, the lender will typically resell the foreclosed property—the REO—much the same as in non-judicial foreclosures. Specifically, the lender will list the property with a real estate agent who will use the MLS to market it and find a buyer.

Property Criteria

When I started in this business, people would often ask me, "What are your criteria for buying houses?" And my answer was very specific:

> I look for traditional style, single-family houses that were built after 1990, with at least three bedrooms, at least two bathrooms, and a level and usable backyard, and that will resell after renovations for between $100,000–$150,000.

If you asked me why I focused on those types of houses, my answer was simple: Those are the types of houses that were selling in my area! It didn't matter if I personally liked or disliked these types of houses; all that mattered was that buyers in my area tended to like them. If buyers in my area preferred 5-bedroom ranch houses built in the 1950s, then that would have been my buying criteria.

The point is, when targeting properties, personal preference is important to a degree—if you like it, others will also—but much more important than what you prefer is what the buyers in your market tend to prefer. They are your customers, and your job as a business owner is to provide the product that your customers want.

It's also important to realize that just because a certain type of property may be selling very, very inexpensively, that doesn't make it a good deal. Here's an example of that from personal experience.

In my original farm area back in 2008 through 2011, you could find some amazingly cheap single-family homes that had just 1.5 bathrooms. Banks and homeowners were practically giving these houses away, in some cases literally. Some investors in the area got very excited by the low prices on these properties, without considering that it was nearly impossible to resell those types of houses at that time.

Here was the relevant data that I pulled up when trying to decide if I should be buying some of those houses:

In 2010, in the zip code where I focused most of my investing, there were 318 retail sales. Of those 318 sales, exactly six of those had fewer than two full bathrooms. In other words, at that time, only 2 percent of sales in my market were of properties with fewer than two bathrooms! I'd have been crazy to try to rehab and resell homes with fewer than two full bathrooms, regardless of how cheaply I might have been able to buy them.

(And in case you're wondering, it's not easy to turn a half-bath in a small house into a full bath. The 1.5-bath floorplan is typically too small or cramped to convert a half-bath into a full bathroom within the existing square footage, and it's often too expensive to add the necessary square footage to make an enlarged bathroom.)

Any investor who didn't do the research and assumed that buying cheap houses with 1.5 bathrooms was a brilliant move probably ended up with a lot of unsold houses that year. Luckily, I did the research, and I knew what types of houses I'd be able to resell. You should do the same.

What Characteristics Should You Consider?

Based on the above anecdote, it should be obvious that I can't tell you specifically what types of houses you should be investing in, and what property characteristics you should be looking for. However, I can give you a general overview of the property characteristics you should be thinking about and then you can do some research to determine what specifically is selling, and not selling, in your market.

Here are the most important property characteristics you should be investigating when determining what your specific property criteria is:

- **Property age:** In most areas, there were housing booms at several points over the past 100 years. In my experience, houses built during the most recent boom—ignoring any current new construction spikes—will be the most desirable to potential buyers, while the boom previous to that makes for the best rentals. For example, in Atlanta, prior to the current wave of new construction, there was a housing boom in the 1970s and then again in the mid-1990s. As a rehabber starting in 2008, I focused on houses built in the 1990s; many of the landlords I know focus on properties built in the 1970s. Again, this is a general rule, and your data will tell you for certain.
- **Property style:** In most areas, there are going to be certain styles of houses that predominate the landscape. In general, these are the types of houses buyers prefer in that area. However, that's not always the case. For example, historically, there have always been many single-story ranch style houses in my farm area, and you'll still see many of these houses around. However, buyers now prefer more traditional style houses to the ranches, which tend to be more popular as rentals. So again, make sure you have the data.
- **Construction type:** You'll want to know if your buyers prefer framed houses, brick, stucco, etc. While most construction types will get the job done, there will be some preferred styles in your area, and these will be the houses that the buyers are naturally attracted to.

  Remember, don't assume that others want the same thing you want, especially if you come from a different area. A great example here is that I dislike basements, both as a homeowner and as an investor. To an investor, they are money pits. However, most of the buyers in my area love basements, so I'd be a fool to pass up a great house with a basement just because of my personal preferences.
- **Number of bedrooms and bathrooms:** In all areas, there will be a minimum number of bedrooms and bathrooms that are needed to sell a property quickly. In my area, it used to be three bedrooms and two bathrooms was the minimum; over the past few years, it's transitioned

to the point where buyers are demanding at least four bedrooms and two baths. So, this is our new criteria.

- **Lot size:** Depending on your area and your buyer demographic, you may see trends in the types and sizes of lots that tend to sell quickly. For example, in more rural and suburban areas, buyers are going to be accustomed to larger lots, with flat lots preferable to hilly lots; in cities, any private exterior space may tend to help the property sell quickly and at a premium. It's important to know what types of lots are expected by the typical buyer and ensure that your property has it.
- **Subdivision or stand-alone:** You will often hear that you shouldn't buy investment property on busy roads, but I'll take that one step further: In many areas, buyers are going to expect not just non-busy roads, but also a well-defined subdivision. Subdivisions may have amenities that buyers want, aesthetic standards that buyers find attractive, or may just provide the privacy that your buyers expect. When considering a property, make sure to consider whether your potential buyers will expect it to fall within a subdivision or not, and how that will affect your future sale.

You may find several other property characteristics that tend to be common or uncommon in your particular market, and you'll be wise to take note of how those characteristics will impact your ability to buy and sell properties in that area. This doesn't mean that different is always bad, but consider that if most buyers are looking for a certain type of house, it will be easier to sell that type of house than another type.

All that said, here are some general rules that I've come to learn over the years. Keep in mind that some of these may be difficult to glean by just looking at historical sales data:

- When buying in a subdivision, the nicer the subdivision, the farther back from the main road you'd like the house to be; the more run-down the subdivision, the closer to the front of the neighborhood you'd like the house to be. In other words, the more unkempt houses potential buyers see before they arrive at yours, the less likely they are to be impressed with yours.
- Houses where the neighbors have barking dogs or other animals in their yards can be very difficult to sell.
- Houses with no attached garage are harder to sell.
- Houses with fewer than three bedrooms and two baths are very

difficult to sell.

- Houses without usable yard space are difficult to sell in areas where the bulk of the buyers are families.
- Houses on busy streets are difficult to sell in areas where the bulk of the buyers are families.
- Houses near schools are difficult to sell in areas where the bulk of the buyers have no kids.
- Houses with outdated floor plans are very difficult to sell.
- Houses with pools can be tricky. Make sure you have a good understanding of who your target buyer is before buying a house with a pool. In my experience, a house with a pool may sell for a premium, but your target group of potential buyers will be much smaller.

Level of Renovation

Especially early in your rehabbing career, you're going to want to be selective about the types of renovation projects you jump into. I've seen a lot of new investors get in over their heads on their first or second project by trying to tackle a renovation that was either risky or required a great deal of construction knowledge, scheduling ability, or custom design work.

While you don't necessarily have to stick to "paint and carpet" rehabs when you start out, you should have an idea of what your skill set is, what your level of risk tolerance is, and how much stress you're willing to incur on the early projects. When I look at a house, I will often characterize the level of renovation by placing the project into one of four levels, as follows:

COSMETIC	ADVANCED COSMETIC	MECHANICALS	ADVANCED
PAINT	CABINETS	HVAC	FOUNDATION
CARPET	COUNTERTOPS	RE-PIPING	MOLD
APPLIANCES	DOORS	RE-WIRING	STRUCTURAL
LIGHTS/FANS	WINDOWS		ADDITIONS
SINKS/FAUCETS	ROOF		
DOOR HARDWARE	SIDING/GUTTERS/TRIM		
OUTLETS/SWITCHES	MAJOR TRIM/DESIGN		