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THIS IS NOT YOUR GRANDFATHER'S 'ROOMING HOUSE.'

Riches in Niches

by Kelly Edwards and Chris Edwards

As students of real estate investing for the last 13 years, we've seen—and participated in—quite a few strategies related to single-family and multifamily investing. We have learned a great deal along the way, but one timeless lesson remains far superior to any other: buy where the numbers work. Sounds simple enough, right? Sure, until the day you make that first offer.

For a traditional buy-and-hold strategy, it seems logical to simply acquire the lowest-priced property in the best possible neighborhood and seek the highest rent the market will bear. Problem solved, right? Again, not so fast. Experienced investors understand that, generally speaking, the lowest-priced properties typically do not return the highest rents, for many reasons. So what's an investor to do?

Let's look at some viable options for building wealth by acquiring, rehabbing and managing the traditional low-cost property, often referred to as "the $30,000 house." But be forewarned: This requires a wide-open mind and some "out-of-the-house" thinking.

Are you ready? Let's go!

THE TRADITIONAL $30,000, BUY-AND-HOLD MODEL

Much has been written about the upside as well as the challenges of investing in the prototypical low-cost property. For the purpose of this discussion, let's set some parameters about our $30,000 property. A low-cost investment will be defined as an all-cash purchase of a single-family house with a total cost landing somewhere between $30,000 and $60,000. This cost includes the investor outlay for acquisition, closing and rehab expenses. This is a C to D Class two-bedroom, one-bath, 1,200-square-foot older home—built between 1900 and 1960. Understand that this range may vary depending upon location and many other factors. We will also presume that the investor is local and will self-manage the property.

THE 10,000-HOUR RULE AND NICHE REAL ESTATE INVESTING

As the often-repeated adage goes, "the riches are in the niches." For most business owners, mastering a particular niche can be quite profitable. But it takes a commitment of time and effort. In the New York Times bestseller "Outliers: The Story of Success," author Malcolm Gladwell cites "the 10,000-hour rule" in positing that the focused and diligent practice of one's craft will ultimately make one an "expert." Likewise, we contend (backed by our own experience) that focusing on a niche will increase the likelihood of success as a real estate investor.

THE SHARED LIVING REAL ESTATE MODEL

One such niche is the Shared Living Model. This is one strategy that our company pursues in seeking diversification and wealth creation by acquiring, at a lower cost, single-family properties and converting them into quality shared-living space.

Before you jump to the assumption we are proposing a "rooming house of old" model and turn the page, let us assure you we are not.

This effectively turns a traditional single-family house into a systems-based, scaled-down version of a multifamily dwelling, providing numerous benefits for both investors and occupants.

The neighborhoods where we purchase such properties often are located in the path of a city's plan for redevelopment and growth, or just ahead of the curve of currently high-appreciating areas. The suppressed prices are indicative of the location and condition. As an element of this strategy, such properties are held in our portfolio for an average of three to five years, allowing the local wave of urban renewal to reach the subject areas and provide increased appreciation over a longer term. In so doing, we as local investors are able to purchase lower-priced properties and truly make the numbers work.

Conceptually, the strategy is simple. Implementation, however, is more involved.

We have been able to succeed by acquiring low-priced single-family properties and then using a very systematic and fairly automated process to convert each to a functional, code-compliant, small multifamily unit. That enables us to more than triple the gross rental income and subsequently provide a generous return on our investment capital.

While the idea of room rentals may not sound appealing to some at first glance, there is remarkable potential to enhance one's real estate portfolio.

TURNING THE TIDE

To be certain, there is a stigma attached to the "rooming house" concept and the image of slums that it conjures for many. Unfortunately, even in our area there are some landlords whose property and behavior still fit that stereotype.

But our company is seeking to change that. There also is a nice element of goodwill involved in our approach, as our properties provide a safe and clean place for applicants with limited housing options to call home.

We often encourage local mentees or investor partners to drive by some of our properties and identify the ones that are part of our Shared Living portfolio. They are pleasantly surprised to see that,

other than being situated in a particular neighborhood or area within the city, the character and condition of the houses alone are almost identical to our A and B Class higher-end rentals.

Let's take a closer look at the Shared Living Model and five reasons it is a viable investment option for the savvy real estate investor:

5 BENEFITS OF A SHARED LIVING APPROACH

1 REAL ESTATE SYSTEMS AND AUTOMATION

In our experience, the key component of a successful Shared Living Model is a well-defined repeatable system. First, it's important for investors to recognize that any business—real-estate-related or not—should be treated as a business. Whether a real estate investor owns one unit or 100, developing a system with repeatable processes is a necessity. Second, a system must be implemented to manage the business, or the business will certainly manage the owner! The business of real estate can get out of hand quickly and overwhelm even the most experienced investor. Trust us, we know this firsthand.

It's no secret that, generally speaking, lower-cost properties require more attention from the owner or manager. Through years of experience, just as we were able to do with our A/B Class portfolio, we analyzed each phase of the room rental cycle, from advertising and tenant screening to move-out and deposit disposition.

The goal was simple. First, address each of the challenges associated with the standard rooming house such as tenant hassles, chasing rent, late-night calls, evictions, etc. Second, build a system that would mitigate as many of the issues as possible. Then, if the system worked, we had a legitimate business model.

Through that exercise, we have streamlined, automated or outsourced the following common tasks (in addition to others) that are typically related to all single-family and multifamily rentals, but more specifically for the Shared Living Model:

- All forms of communication (applicants, tenants and maintenance)
- Documentation (operations manual, policies, checklists, forms, etc.)
- Advertising and unit-showing process
- Application and approval process
- Lease signing
- Rent and deposit collection (no rent closets or chasing money)
- Move-in coordination
- Unit inspection
- Move-out coordination

2 SUPERIOR PRO FORMA RESULTS

One of the more obvious benefits to the Shared Living Model is the relatively superior pro forma when compared to a traditional $30,000 buy-and-hold investment. To better understand the differences in cash flow and ROI, let's analyze a pro forma of a property in our market, Raleigh, N.C., using actual numbers that work.

The accompanying chart illustrates how three different strategies affect the numbers.

(Note: Pro forma numbers in the chart reflect our current rental portfolio, market and competency. Results may vary, depending upon factors such as property location, owner-manager skill and competency, among others.)

TRADITIONAL LOW-COST MODEL

In this scenario, assuming the $30,000 purchase price and additional closing and rehab costs, the total (all-cash) acquisition investment is $42,500. This property rents for $600 per month. Related expenses are shown in the chart. Many investors do not account for repair and maintenance (10 percent) expenses, and even more fail to allocate a reserve for capital expenditures. Such planned expenditures will cover the future replacement of a property's aging components including appliances, roof, etc. In this example, we have allocated a fairly conservative 25 percent, or $150 per month. Based upon this pro forma, the cash flow results in a meager $144 monthly or $1,728 for the year. The cash-on-cash return of 4.1 percent isn't the investment return one would hope to achieve. This scenario serves as an example of how many new investors can be surprised by the harsh reality and challenges of acquiring $30,000 properties.

SELF-MANAGED/SHARED LIVING MODEL

The self-managed option is the sweet spot of the Shared Living Model for the fairly experienced investor. We suggest owner-managers have a minimum of

> CONCEPTUALLY, THE STRATEGY IS SIMPLE. IMPLEMENTATION, HOWEVER, IS MORE INVOLVED.

THE REAL ESTATE RICHES ARE STILL IN THE NICHES – WITH THE RIGHT PROCESSES IN PLACE

How Savvy Investors Can Purchase $30,000 to $60,000 Properties Using A Systematic Approach

	TRADITIONAL	SELF MANAGED	PROPERTY MANAGER
*ALL CASH			
PURCHASE PRICE	$30,000.00	$30,000.00	$30,000.00
CLOSING COSTS	$2,500.00	$2,500.00	$2,500.00
REHAB COSTS	$10,000.00	$15,000.00	$15,000.00
TOTAL	$42,500.00	$47,500.00	$47,500.00
SQUARE FOOTAGE	1200	1200	1200
# BEDS (DOORS)	2	4	4
# BATHS	1	1	1

MONTHLY INCOME

	TRADITIONAL	SELF MANAGED	PROPERTY MANAGER
GROSS RENT	$600.00	$2,080.00	$2,080.00
LESS VACANCY	$60.00	$208.00	$208.00
NET RENT	$540.00	$1,872.00	$1,872.00
EXPENSES			
CAPEX RESERVES	$150.00	$520.00	$520.00
TAXES	$66.00	$67.60	$67.60
INSURANCE	$60.00	$62.40	$62.40
MANAGEMENT	$60.00	$0.00	$312.00
UTILITIES	$0.00	$228.80	$228.80
REPAIR & MAINTENANCE	$60.00	$208.00	$208.00
TOTAL EXPENSES	$396.00	$1,086.80	$1,398.80
MONTHLY NET CASH FLOW	*$144.00*	*$785.20*	*$401.20*
YEARLY NET CASH FLOW	*$1,728.00*	*$9,422.00*	*$4,814.40*
CCR% (Cash on Cash Return)	*4.1%*	*19.8%*	*10.1%*
Monthly Gross Rent Per Door	*$300.00*	*$520.00*	*$520.00*
Yearly Net Cash Flow Per Door	*$864.00*	*$2,355.60*	*$1,203.60*

two years of experience managing their own property portfolio before testing the Shared Living waters. Again, the benefits are tremendous, but organization and experience in investment real estate is a must. More detail will be provided to this point in the next example.

For now, contrast the traditional low-cost scenario with that of the scenario wherein a local investor purchases the same property for $30,000. The acquisition costs are identical, with the exception of an increased allocation of $15,000 for rehab expenses. The additional rehab costs are due to the conversion of the interior of the property (most often, the common area space) into two additional bedrooms. From experience, we have learned that the cost to "add" two bedrooms is relatively inexpensive.

The glaring difference one will notice is a much higher monthly gross rent: $2,080 per month, compared to $600. (No, that's not a typo!) Notice the gross rent per room is $520. We have found this to be a consistent number for our local Shared Living Model. We typically see an average gross rent per room of $500 to $550 monthly. Based upon this pro forma, the cash flow is quite impressive at almost $800 monthly and approaching $10,000 annualized. Depending upon one's philosophy toward an adequate CAPEX allocation, the cash flow could be higher. In this case, we're very satisfied with a 19.1 percent cash-on-cash return.

OUTSOURCED PROPERTY MANAGEMENT / SHARED LIVING MODEL

Before we review the pro forma, it's important to understand that the most successful implementation of the Shared Living Model is by the local owner-manager. The respective pro forma data makes this fact abundantly clear. So why suggest using a property management company to run one's shared-living property? Well, to be clear, we suggest this only as a fallback or safety option—for a few reasons.

First, this is beneficial for the veteran owner-manager who experiences some form of change in life circumstance. Yes, life happens, and from time to time, we are forced to make drastic changes.

Second, if the investor must hand over management of the Shared Living property or portfolio, it's important to understand that not all companies may take over the management of such properties. Still, there are plenty that will, due to the functional similarities to small multifamily dwellings. Nevertheless, we suggest seeking the services of a firm that specializes in this form of property management.

Referring to the chart, a quick glance at the property management fee reflects the only variance between this scenario and the previous self-managed example. However, it's a fairly substantial variance. Why is the management fee 15 percent ($312) as compared to 10 percent for the traditional model? This reflects the likely increased cost associated with a management company taking over a room-rental property as described above. Based upon this pro forma, the cash flow for this room rental property—with a property management company in place—is north of $400 per month, or just shy of $5,000 per year. Again, depending upon one's philosophy toward an adequate CAPEX allocation, the cash flow could be substantially higher. This scenario results in a 10.1 percent cash-on-cash return.

3 LOWER ACQUISTION COST

The point here is obvious. The cost to enter this market is substantially lower—and for this reason, we favor buying low and renting high.

4 MINIMAL MARKET COMPETITION

Let's face it, playing in the C/D property class game is for experienced investors—or it should be, in our opinion. For this reason, it's safe to say that, on average, less competition exists overall.

5 INCREASED RENTAL DEMAND

Our company offers a centrally located, code-compliant, very clean, well-run, Shared Living space. Our longer-term, low-hassle tenant base reflects these conditions and amenities that are certainly unique to this age-old neglected asset class. Further, these residents often have limited options in finding a clean, habitable, safe environment. Strict screening, application and income requirements play directly into the success of our system. It's worth noting that we do not accept Section 8 vouchers. While Section 8 is a great program, we have decided to leave this alternative to other investors.

There's little debate that acquiring $30,000 properties has its challenges for real estate investors. It's our belief that whatever strategy one chooses to implement when investing in low-cost opportunities, it should entail a streamlined and systematic approach to ensure success over the long term. •

BY KELLY EDWARDS AND CHRIS EDWARDS

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