How to Invest in the Best Real Estate Markets

A Guide To Out of State Investing

This report will tell you everything you need to know to safely invest out of state, including:

- 5 Reasons NOT to invest locally
- How To Think Like an Investor Not a Landlord
- How to Identify & Choose a Market
- How to Identify a Good Neighborhood
- How to Work with a Turn-key Provider

A Pinnacle Perspective
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PINNACLE INVESTMENT PROPERTIES
REAL ESTATE INVESTING MADE SIMPLE

How to Invest in the Best Real Estate Market And Live Where You Want.

Anyone who has ever bought real estate has probably heard that “Location, Location, Location” is the most important factor in deciding what property to buy.

This is particularly true of investment property which is why I think the popular mantra “never invest more than a 3 hour drive from your home” is outdated and bad advice—unless of course, you happen to live in one of the handful of top investment markets in the country.

Like any investment, real estate has risks so why handicap yourself before you even start by limiting where you can invest? You wouldn’t choose a stock just because the company’s headquarters are located in your hometown and you can drive by and see their building would you? Of course not. You invest based on the company’s financial performance and fundaments which is how you should view real estate also. Invest where the money is regardless of where that happens to be.

Think like an investor, NOT a landlord.

There is a difference between a real estate investor and a landlord and you must decide which you want to be. A landlord manages tenants and property. ***An investor manages financial performance and return on investment.*** If you spend most of your time driving around looking at your properties and dealing with leaky faucets and collecting rent, you will never be successful as an investor. If you truly want to create wealth, you need to develop an investor mindset and think of real estate like any other asset class.

A strong remote market trumps a weak local market any day.

A weak local market is a far riskier proposition than investing in a strong out of state market. In fact, investing in a weak market is more than risky. It’s a sure path to failure and one of the top reasons that inexperienced investors fail and give up. I’ve heard many disgruntled people say that they’ve tried real estate investment and it doesn’t work. If that were true, then how come so much wealth is created through real estate? Often times, the problem has been that they were not investing in the right market for their particular investment technique.

Rather than focusing on how close your investment is to home, you want to invest in the market that best matches your strategy. I repeat, you should invest in the market that gives you the best chance of achieving your financial objective regardless of where it is.

This means that before choosing where to buy or what to buy, you must define *why* you are buying. Are you buying to make a quick profit on a short term fix and flip, for long term cash-flow or for future appreciation? No one market is best for all three objectives. A good rental market may not be good for flipping and vice versa. So start with a clear plan then choose the market that fits your plan best.

Certain investment strategies are better suited for out of state investment than others. For instance, it is very difficult to manage a fix and flip remotely because of how labor intensive it is and how much daily oversight is required. Buy and hold rentals on the other hand are far less labor intensive and with a good property manager do not require a tremendous amount of oversight. For the purposes of this article, we will focus on a buy and hold rental strategy.

Investing outside of your local market does have more challenges but with today's technology, they are easily overcome and the returns can make it well worth it. Information and knowledge are the keys to successful investing and the Internet has leveled the playing field for the out of state investor today.

5 Reasons <u>NOT</u> to Invest in Your Local Market

1. Your market doesn't fit your objective

Remember, you always want to start with a clear objective and choose the market that best supports it. Although you might be tempted, don't make the mistake of bending your objective to fit your market. That's a sure recipe for failure. If your objective is cash-flow through buy-and-hold, then high cost markets like San Francisco and New York won't be good choices. If you live in one of these cities, you'll have no choice but to look to non-local markets such as Indianapolis, Kansas City, Memphis or other less expensive markets that will cash-flow. I often hear Californians say things like "the cash-flow isn't as much as I want but I'm counting on it appreciating." If cash-flow is your primary objective and the cash-flow isn't as much as you want, then it's not the right investment. Most investors look for at least a 1% rent-to-price ratio. In parts of California where the median price of a home is $600,000 and rents for $2500, you can clearly see that the numbers don't work. On the other hand, in a market like Indianapolis or Kansas City where you can buy a property for $70,000 that rents for $900 per month, you can easily meet your objective.

2. Your market is weak or struggling

Cities with high unemployment, declining wages and shrinking populations are not going to be good investment markets. Detroit is a good example. Although some investors are drawn to these kinds of markets because of the low home prices and the high ROI on paper, finding good tenants and keeping properties rented is a real challenge when people aren't working and the prospective tenant pool is shrinking. It's even harder to raise rents down the road even though your costs may be going up.

3. Your Market is too volatile

Volatile home prices and rents are the enemy of financial planning and return on investment. Volatile home prices make a fix and flip particularly risky and fluctuating rents makes cash flow unpredictable. Areas that experienced extreme "bubble/burst" cycles during the last real estate crash tend to be highly speculative. Many people have flocked to these markets with the belief that "what goes down must go up" and in some of the most severely impacted markets like Phoenix, Las Vegas and Tampa, that appears to be true. However, these recoveries may be short lived with the possibility of a second "bubble". Much of the growth in these markets' economies before the 2008 recession was driven by construction and real estate and with a lack of new construction those jobs are not coming back anytime soon. The housing price recovery in these markets has been largely investor driven, through the big hedge funds. It has not been a result of improved economic conditions and homeowner demand for housing which is necessary for a strong, sustained recovery.

4. Don't put all of your eggs in one basket.

Even if your local market is strong and meets your objective, you may not want to have all your eggs in one basket. If you're expanding your portfolio and already have a number of properties in your local market, you should ask yourself if it's time to diversify. This is part of the investor mindset. Just as you wouldn't put your entire stock portfolio in one stock, you shouldn't put your entire real estate portfolio in one market. Think strategically and adjust your real estate portfolio accordingly.

5. A good market today may not be a good fit tomorrow.

Your local market may have been the best when you started, but that doesn't mean it will always be the best. One thing for certain is that nothing stays the same and markets change. Forbes and other magazines publish a list of the top cities in which to live or invest periodically. These lists don't stay the same. They change over time. The best cash flow market one year might not even make the top 10 five years later. Maybe your cities economy has weakened. Maybe a major employer cut their workforce or pulled out. Maybe rents are stagnating or declining. There are all kinds of reasons that rental markets change and you should be flexible to change with them. Using the stock market analogy again, you probably wouldn't keep a once good performing stock if the company has fallen on hard times and the stock price has been continually declining. Don't hold on to real estate that's no longer performing well just because it's in your backyard. Markets are cyclical so you must be prepared to adapt.

When your market changes you have two choices. You can either change your investment technique or change where you invest. Personally, I think the latter is the better choice. If you already have a strategy that you are comfortable with and it works, why mess with success? It's much easier to find a new market then it is to learn a whole new strategy.

Now, if you agree that it's important to think like an investor and not a landlord, the next challenge is how to go about investing in an unfamiliar market.

Unique Challenges of Investing Out of State

Most of the challenges and risks of investing out of state are the same as those of investing in your local market. You can have problem tenants regardless of where you invest just as you can have leaky faucets, backed up drains and water heaters break. These are not unique to out of state investing.

There are some unique challenges to investing out of state however, that you must know in order to mitigate the risk. These are the four 4 challenges that are unique to investing out of state.

1. Not knowing the market.

When you don't live in a particular city, you don't have first hand knowledge of the cities economy, industries, job market and population trends which are key indicators of the health of a market. Understanding the economic and demographic is not difficult. Fortunately, all of this information is for any Metropolitan Statistical Area (MSA) is readily available at your fingertips. The vast majority of it can be found on the Bureau of Labor Statistics and U.S. Census Bureau websites. Local newspapers are also available online and are an excellent source of information on a market.

2. Unfamiliarity with the neighborhoods

Just as important as investing in a good market is investing in the right neighborhood. This is one of the biggest mistakes new investors make and will make or break an investment. Too often, out of state investors focus their research and due diligence on the market and not enough on the submarket or neighborhoods. Investing in a bad neighborhood is a costly mistake and one that can't be fixed. A bad tenant can be evicted or a broken furnace can be replaced. But you can't move the house to a better neighborhood, which brings up a very important point. Cheap houses in bad neighborhoods are not good investments, especially for the out of state investor.

There are two simple ways of getting an understanding of a neighborhood. First, look at the crime rates. Although not foolproof, Trulia heat maps can be very helpful in identifying the crime rate of an area. Next, look at the business establishments in the area. Are there a lot of strip malls with liquor stores and check cashing businesses? Does the area have a lot of apartments and multifamily housing? Is the area zoned for mixed use i.e. industrial, commercial, residential? Then familiarize yourself with the median home prices and rents in the area. Look properties priced at 70% to 100% of median price and rents at 80% to 100% of median rents. Properties priced far below the median with rents below the median will be in rough, lower class neighborhoods.

3. Not being able to view the property

Buying a property site unseen can be very disconcerting, especially for new investors. Often time there is no choice however. Properties sell quickly in good markets and often times are sold before you can fly out and see it. The most important reasons to see the property is to determine the condition of the property and to also know whether there is any functional obsolescence which would make it hard to rent. These challenges are fairly easy to mitigate. If the property is turn key, ask the turn key company what their renovation standards are for every property and then ask them for a scope of work for the rehab. Get good post rehab pictures of every room. Lastly, never buy a property without getting your own independent home inspections. Doing these things will greatly reduce the risk of not seeing the property.

4. Managing maintenance and repairs.

This is most critical when it comes to tenant turn-over and getting the property rent ready. The cost of making a property rent ready at turn-over depends on how long the tenant has been in place and how gentle they have treated the home. It can range from as little as a few hundred dollars to thousands of dollars. Your property manager will create a punch list of what they say the property needs and an itemized list of the cost. But how do you know that everything they are recommending needs to be done? The property managers objectives may not be the same as yours. Property manger's want your place to be as pristine as possible because it makes their job of renting it much easier. But sometimes not everything needs to be done to attract good tenants. This is where working with excellent property mangers that you know and have a trusted relationship is so important. Screen your property manager well.

The 2 major steps to investing out of state are:

1. Choosing the best market
2. Finding the right properties

How to Choose the Best Market

There's a lot more to choosing a good market than finding cheap houses. In fact, you shouldn't even look at houses until you have identified markets with strong economic and demographic fundamentals first. Cheap houses do not mean good markets.

With all of the information and resources available through the Internet, researching other markets has never been easier. You'll want to start at a macro level and drill down. The way to do that is to identify several Metropolitan Statistical Area's (MSA's) that look interesting to you. There are 381 MSA's in the U.S. which leaves you with no shortage to choose from.

You need a large rental pool, so start with the larger metropolitan areas. MSA's with populations of 500,000 or more are a good start but some investors are ok with populations of 100,000 or 200,000.

Once you've identified some promising markets, you'll need to research the economic and demographic fundamentals of the city. You want to get a good understanding of the economic health of the area.

The 5 most important factors to consider are:

Population trends. This is one of the most important considerations when choosing a market to own buy and hold rental property. If the population is decreasing, you not only have a shrinking pool of renters, it's a sign of fundamental economic weakness of the area. Thriving, healthy cities don't have declining populations. Look for cities with population growth that exceeds the national average and a positive net migration where more people are moving in to the city than moving out. This is a pretty good indication that the city has something to offer to attract more potential renters.

Jobs and Employment. Simply looking at unemployment rates can be misleading. Drops in the unemployment rate can be due to people dropping out of the labor force or losing unemployment benefits eligibility. Some highly depressed markets could show low unemployment rates because a high number of people have simply given up looking for work and are no longer counted as part of the labor force. Instead, look at the net positive jobs being created. You'll also want to know about the types and quality of jobs. Are they full time, well paying jobs? Investors should always want to know what the major industries and employers are in the area. Are they in growth industries? Is there diversity of industry? Is the area a hub for a major industry? Research what companies are doing in the area. Are any major employers moving in or out of the city? Do any have expansion plans? Are they hiring or laying off employees?

Income Growth. Look at per capita and median household incomes. Are incomes going up, down or are they stagnant? Again, cities with thriving economies have rising incomes and are producing higher wage jobs. If the number of people employed is rising but average incomes are declining, it means that the new jobs being produced are mostly lower wage jobs. So, it's not just the number of jobs that's important, it's the quality of the jobs.

Investment in the city. Government and private investment in infrastructure and redevelopment is key to a cities vitality and economic development. Investment in museums, convention centers, hotels and airports creates jobs and increases the tax base for a city. Research what redevelopment projects and plans the city has and how much is budgeted for them.

Size of the economy. Gross Metropolitan Product (GMP) is a gauge of the size and health of an economy. GMP represents the value of all of the goods and services produced over a certain period of time. You'll want to see what the absolute GMP is in dollars and also, whether it is growing or declining. Cities with large populations typically have higher GMP than smaller cities so it's helpful to look at the GMP per capita of a city. Markets with GMP growth that exceeds the national average and high GMP per capita could be good choices.

Once you have a good understanding of a market's economic fundamentals, you'll need to know some key things about the local housing market.

The most important housing factors you need to know are:

- **Rent-to-price ratios.** How much do properties rent for compared to the cost to buy them? This is the most important factor that will determine if an investment is a good one or not. You'll want to look for markets that have high rents and affordable home prices. Most investors look for rent-to-price ratios of at least 1%. The higher the better.

- **Vacancy rates.** Some markets such as Cleveland and Detroit have had so many vacancies that the cities are bulldozing neighborhoods to reduce the cities geographic footprint. These probably aren't the best markets to invest in. Look at what the rental vacancy rate is in your target market. Once again, look at the trends. Are vacancy rates increasing or decreasing? How do they compare to the national average?

- **Housing price trends.** What's happening with housing prices? Are they going up or down? Look at the trend of median prices in the market. Nearly all markets took a beating in 2008. Look at how much prices dropped from their peak to their low in your target market. Some markets lost 60% of their value while some lost less than 10%. Where are prices now in relation to their high and low? Where are they in the recovery cycle? The ideal time to buy is in the early recovery stage of the cycle.

- **Operating costs.** No matter how good your rent-to-price ratio is, high operating costs can kill your cash flow. The operating costs that can vary most from one market to another are property taxes and homeowners insurance and can account for over 50% of your operating expenses. Florida and Texas compete for the top cities having the highest homeowner's insurance rates with average premiums of $1,534 and $1,482 respectively. Texas also has the dubious honor of the 3rd highest property tax rates in the nation. This does not necessarily mean that these are not good investment markets. It will however make it harder to reach your cash-flow and ROI objectives.

- **State and local regulatory bodies.** Is the city and state tenant-friendly or landlord-friendly? Be careful of markets that have such onerous regulations that it is difficult to get rid of a bad tenant. In some states, it's possible to evict a bad tenant in 2-3 weeks with nominal court fees. Other states like California, so heavily favor the tenant it can take months and a great deal of expense.

How to Buy Properties in Your Chosen Market

So now that you've identified a great market, it's time to roll up your sleeves and find a property. This is where the real work begins. Remember that real estate markets are made up of lots of micro markets and can vary neighborhood to neighborhood. You want to make sure the property is in a safe, stable neighborhood. A key thing to remember is that you are not living there, so don't let your personal tastes or criteria drive your decision., however, you'll want to avoid bad areas. **Your main consideration is, can you attract good tenants at a good rental rate?**

Remember, as we said earlier, cheap does not make a good market and the same applies to a property. Many investors are drawn to cheap properties because the returns look good on paper, however, those returns often disappear with high vacancy rates, turnover and vandalism. I often hear investors say that they know they'll have more headaches with cheap properties but the higher returns are worth it. What they are not considering is that those headaches are not free. Vacancies and turn over are the biggest killers of cash flow and no matter how good a property manager is, good tenants don't want to rent in bad areas.

How to identify good neighborhoods

Two factors will be an indicator of a good or bad neighborhood more than anything else.

1. Crime rate. Is it a high crime area? It's easy to research crime rates in any area using heat map online tools such as that available on Trulia.
2. Rental rates. Cheap properties have cheap rent. Compare the rent to that in other areas.

In general, high crime areas with low rents will be more difficult to manage. No matter how good your property manager is, they can't convince good tenants to live in bad neighborhoods.

Once you've identified a good area, you can now start looking at houses.

When you are ready to do this, there are 2 approaches that you can take. Which choice is right for you will depend on your available time, skill and experience.

1. Do the work yourself (DIY)
2. Buy a turn-key property

Do-it-Yourself

Some investors will try to save money by doing all the work themselves. That entails building a network of the right people with the right skills. That network includes a real estate agent, contractor, property inspector, property manager, lender and insurance agent. Some people have the time and skills to do this. Most do not. Most people are busy with life and work and don't know where to start so they never take action. Or worse yet, they make costly mistakes. One wrong choice can be the difference between an investment that makes you money and one that loses money.

There are several risks of doing it yourself. Other than picking a real estate agent or contractor that doesn't have your best interests at heart, there are uncertainties and unknowns with buying and renovating property. One of the biggest uncertainties is renovation costs. Underestimating construction costs or identifying unforeseen problems during renovation can be very costly. Another common mistake is overestimating the potential rent before buying. Often times, an investor will rely on their real estate agent who is not a property manager for a rental estimate, and are disappointed to find after renovating the property, they can't rent it for as much as they expected. These two risks alone can wipe out any savings of doing it yourself. Unless you are an experienced investor and have the time and the right skill sets, this is a risky way to go.

Turn-key

The easiest and least risky way to invest out-of-state, or if you are just getting started in real estate investing, is to buy a **turn-key** property. With turn-key properties, all of the work is done for you, from renovation of the property, to collection of the rent. You don't have any of the headaches of buying a distressed property, renovating it, finding a tenant and managing it.

It's much easier to establish a relationship with one turn-key provider that you trust than building a network of people that you can trust and manage. Plus, it takes the risk and uncertainty out. Because the renovation is already done, there won't be any construction overruns or surprises. And since the property is already rented, you'll know exactly what the rent is.

Additionally, turn-key companies typically have more sources of acquiring properties, including auctions, tax sales and wholesaler networks that allow them to buy at lower prices than the individual investor. They also have more economies of scale when buying materials and negotiating with contractors. Because of all of these factors, the savings by doing it yourself can quickly disappear.

How to Work With a Turn-key Company

There are several turn-key companies to choose from, so make sure you are working with the one that is right for you. When buying through a turn-key company, you are getting not just a finished product, but also that companies knowledge and expertise in a market. That is one of the primary values that a good turn-key company provides, so make sure that they truly know the market in which you are buying. Most turn-key companies offer properties in several markets. You'll want to make sure that they have an in depth knowledge of the neighborhoods in all of the markets that they serve. Some turn-key companies offer properties in so many markets that they can't possibly have expertise in all. In fact, they may not have even visited all of them. It's important that the people you work with visit the markets regularly and know them down to a neighborhood level.

It is best to visit the city at least once if at all possible. During your visit, you'll want to see the neighborhoods that you're buying in. Become familiar with the area. Many cities vary from block to block and even street to street. Identify the troubled spots in an otherwise good area so you know to avoid it. Mark the areas you like on a map as you drive around so you can identify them when you go back home. Ask your turn-key provider to show you the inside of some of their properties so that you can see the quality and standards of their rehabs. If you're going to be buying several properties over a period of time, it's not practical or even feasible to go and see each property before you buy, so the primary purpose of your visit is to learn what areas fit your criteria so any time a property is available in that area, you can buy with confidence without having to make a trip there each time.

Here are the things that you should address with your turn-key provider:

1. Communicate your investment goals and objectives with them.
2. Understand their process and how they work.
3. Ask what neighborhood classes they operate in and why
4. Ask them to explain the assumptions in their pro forma cash flow projections
5. Find out how long they've been in business.
6. How many of their buyers are repeat buyers?
7. What are their rehab and renovation standards?
8. When was the property renovated?
9. Get a scope of work for the renovation done.
10. Get copies of the tenant lease agreement
11. Will they support you after the close of sale.

What to watch out for in a turn key company.

- They don't allow financing or a finance contingency (it can be a good indication they are selling above market value)
- They don't allow for your own independent property inspection
- Are not realistic with their pro forma's (i.e. they don't include vacancy or maintenance projections or use unrealistically low vacancy factors)
- Require you to pay for any renovation upfront. NEVER pay for any renovation upfront.
- Sell only in cheap. low end neighborhoods
- Don't accurately represent the neighborhood/property classification
- Don't have consistent rehab standards for all properties

Summary

Investing out of state is not hard when you think like an investor and not a landlord. By investing in the markets that best match your investment strategy, you can actually reduce your risk and increase your profits. If you're serious about investing, it's time to look beyond your own backyard and explore the many exciting opportunities available around the country.

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