Regular Riches

How Much Investor Discount is Enough?

The spices and seasonings of the gourmet real estate investor

Emeril can't figure out where he made his mistake. He thought he was getting a great deal when he bought a house and got a 10% discount. However, he barely turned a profit on his investment.

Julia also is completely stumped. She bought a house with a 25% discount. However, after selling the property, Julia lost money.

Any cook can try to cover up a bad chicken with salt, pepper, oregano, lemon, paprika and more, but what do you have? Still a BAD CHICKEN DINNER.

In the same light, a real estate investor who starts off with too small a discount on their purchase, can try to make up for it after the purchase with hard work, fancy improvements, and eye-catching advertising. However, what will they still have? Usually, they will still have a BAD INVESTMENT.

So what are the right spices and seasonings (discounts) every gourmet real estate investor should know about? How should they be applied like gourmet chefs Emeril Lagasse and Julia Child?

There are *four key spices and seasonings* that every gourmet real estate investor should know about and understand how to apply. The four key discounts make up the Total Investor Discount and they are the:

- Minimum Investor Discount
- Repair and Improvement Discount
- Negative Property Attribute Discount
- Length of Time on the Market Discount

MINIMUM INVESTOR DISCOUNT

The first is the *Minimum Investor Discount (MID),* which is the minimum profit an investor should receive from any real estate investment. So, what is the minimum profit an average real estate investor should get? 10%? 25%? Perhaps 50%? More?

The answer is….it depends on your real estate investment strategy.

If your strategy is "*buy and flip"*, then all of your profits come from the difference in the Purchase Costs (purchase price, repair costs, marketing cost, holding cost, etc.) and the Sales Price. The differential is your only profit source. Because there is the risk that a property may not sell quickly, many "buy and flip" investors require a *25% or more* Minimum Investor Discount.

If your going to use the *"buy and hold"* strategy, which usually means you're going to rent your property, then you have access to multiple profit sources. These investors have access to the same profit source as the "buy and flip" investors. However, they make much of their profit over an extended period of time from rental payments, appreciation of the property, equity gains from paying down the loan with the tenant's money, and tax write-offs. The pure "buy and hold" landlord has a total of five "profit sources". Therefore, their Minimum Investor Discount can be *as low as 5-10%.*

Finally, if you're going to *"buy and lease/purchase"* your property, then you usually have access to the same five profit sources as the "buy and hold" investor. However, you also gain access to another profit source, option money (the lease/purchaser pays this for the right to buy your property at a later time). With lease/purchases, you need to keep in mind that your property may sell quickly and you may not have access to these other five profit sources. Accordingly, "buy and lease/purchase investors" often need a Minimum Investor Discount in between the "buy and flip" and "buy and hold" discounts. Therefore, they often need a Minimum Investor Discount of *10 – 20%*.

Emeril and Julia both got reasonable discounts, 10% and 25%, respectively. However, they did not make a satisfactory return on their transactions. What happened? Recognizing the appropriate Minimum Investor Discount for your chosen investment model is a good "first step". Emeril actually received the right MID for his lease/purchase strategy….10%. However, when the house took longer to lease/purchase due to some problems he failed to consider and the house sold one year later, he only made $1,000. Julia also got an even better discount…25%. However, when it took her nine months to sell the property, she lost $10,000.

So, where did they go wrong? They used only one of the four spices and seasonings in the Total Investor Discount. A successful real estate investor uses all four, as needed, to make sure their purchases are always savory.

REPAIRS AND IMPROVEMENT HASSLE DISCOUNT

The second of the four key discounts is the *Repair and Improvement Hassle (RIH) Discount*. The basic concept to understand here is that an investor should not complete repairs and improvements that the seller is either unwilling or unable to complete without additional compensation. The investor is assuming risk that the repairs and improvements might be more excessive and costly, the investor is paying the mortgage or finance costs while the repairs and improvements are being completed, and of key importance the investor's time and energy to get these done has VALUE. The "rule of thumb" we use is an additional discount of 1% for every 3% of repairs and improvements as a percentage of the value of the property fixed up.

Emeril's property was worth $200,000 fixed up, and required $48,000 worth of repairs and improvements Therefore, for Emeri's property, $48,000 of repairs equals 24% of the fixed up value. Repairs and improvements of 24% are fairly significant. Emeril had to bear a decent amount of risk, and likely spent a good amount of time managing his contractors. Accordingly, the additional RIH Discount should have been 8% (1% for every 3% or 24% / 3%).

Julia's property had a fixed up value of $100,000 and repairs and improvements of $15,000. Here, the repairs and improvements represent 15% of the fixed up value, and her RIH% should have been 5% (15% / 3%).

NEGATIVE PROPERTY ATTRIBUTE DISCOUNT

The third key discount can be one of the trickiest. Simply put, a *Negative Property Attribute (NPA)* is a problem with a property that cannot be eliminated with repairs and improvements. A good example is a home without a basement, located in a subdivision where basements are common. Another example is the first home in a subdivision that borders a main thoroughfare. This home could be offered for free, and there are many families with kids who would still not even consider this home.

A property's Negative Property Attribute is often the main reason that a property is available at a discount. Therefore, if an investor does not in turn consider a proper additional discount to begin with when buying the property, they run a risk of severely impacting their profits and even losing money. How does an investor account for Negative Property Attributes? The investor does this by asking a critical question: "how difficult will this attribute make it for me to rent, lease/purchase, or sell this property"?

Emeril's property was missing a basement in a neighborhood filled with basements, so the NPA Discount should have been 3-5%. Julia's house bordered a busy street and was on a very steep hill, her NPA Discount probably should have been 6-8% (3-4% for the busy street and 3-4% for the very steep driveway). The more properties you work with, the more you will get comfortable with the appropriate additional NPA Discount specific for each investment

Can an investor simply decide to avoid properties with Negative Property Attributes? Sure, this is possible, but the main concern here is that this will reduce the investor's pool of available investment properties. Most of our best deals come from properties that have Negative Property Attributes. The reason is that these attributes turned off most buyers, leaving investors who know what they're doing as the most likely purchasers of these properties. The key is *not to avoid* properties with NPAs, but rather to *properly account for* the NPAs within your Total Investor Discount.

LENGTH OF TIME ON MARKET DISCOUNT

The final of the four key investor discounts is the *Length of Time on the Market (LTM) Discount*. The theory here is actually quite simple. The longer a home has been on the market, the more likely there are additional issues to deal with. For one, if the property has been vacant for a long period of time, it may have developed problems from lack of use (pipes may freeze over and spring leaks, lack of air circulation can cause molding, etc.). Additionally, the longer a property is for sale, the more chance that a negative reaction in the community becomes attached to it. Accordingly, when you go to sell it, rent it, or lease/purchase it, you may have to discount it to overcome this bad stigma. The good news is that it is often easier to negotiate big discounts on properties that sit on the market for long periods of time because their owners tend to be anxious to sell them.

So, how much additional discount should an investor get for a house that sits on the market for an extended period of time? Our "rule of thumb" is 1% for every month over two months up to 10%. What this means is that we've found that a typical residential property should get a contract on it within two months. After that, the negative stigma begins to attach, vacant houses begin to suffer, and sellers (and their agents) become more anxious. Commercial listings are generally longer and more complicated, so the investor often should not begin adding 1% until after the 3rd or 4th month that the property has been on the market.

Emeril's property was on the market for four months, so he should have received an additional LTM Discount of 2% (for months number 3 and 4). Julia's had been on the market for five months, so she should have received an LTM Discount of 3% (the steep hill and busy street we're probably impacting it).

TOTAL INVESTOR DISCOUNT

Now you know the special spices and seasonings to make gourmet real estate investments. When applying them, we simply add up the four discounts to determine the Total Investor Discount (TID) we need to make the property a winning investment. We then multiply this percentage times the Fair Market Value of the property in repaired and improved condition (based on comparable surrounding properties).

Emeril obtained a $20,000 discount on his investment that he valued at $200,000 (fixed up). However, he paid too much. Yes, he got his MID of 10%, but he did not include the RIH of 8%, NPA of 4%, and LTM of 2%. In actuality, his Total Investor Discount should have been $48,000 (24% x $200,000).

In the same light, while Julia got a $25,000 discount on her real estate purchase, she also paid too much. Yes, she received her MID of 25%, but did not get the RIH of 5%, NPA of 7%, and LTM of 3%. Therefore, her Total Investor Discount should have been $41,000 (41% x $100,000).

Now you might be asking yourself, what if my repair, improvement, and holding costs exceed my Total Investor Discount? The answer…it doesn't matter. As an investor, you should be compensated additionally for these. In other words, the price you pay should not exceed the Fair Market Value (of the property in fixed up condition) minus all costs and your TID, what we call the Maximum Purchase Price or Ceiling Price. If the price exceeds the Ceiling Price, then you're likely making an unsavory real estate investment.

Finally, Emeril and Julia's properties may seem like more trouble than they're worth. However, when we see properties like theirs, we instantly begin to smell the simmering profits and prepare for another gourmet investment. This is because most buyers like properties with little or no problems. Therefore, sellers are usually willing to substantially discount them (if not immediately, eventually). Emeril and Julia may have been able to get the appropriate TID, if they had been patient (sometimes these negotiations will go on for months), and if not, they should have moved on to other properties. As you can now see (or smell), we look forward to finding properties with problems and adding the right spices and seasonings (discounts) to cook up another gourmet investor meal.

Good luck and happy cooking!

Heller and Frank are the co-authors of the best selling, *Fortune Magazine* recommended book *Buy Low, Rent Smart, Sell High* as well as the recently published book *Buy Even Lower*. They go into great detail on properly calculating Investor Discounts in their action program *Buy Low, Rent Smart, Sell High – The Action Program*.