

# 18 Fatal Investor Mistakes

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## **...and the Due Diligence Questions to Avoid Them.**

For the first time real estate investor who is seeking the path to wealth, there is an overwhelming world of options out there. Stories of sudden riches from overnight successes, horror stories of people losing their shirts, and real estate gurus contradicting each other abound. To complicate matters further, real estate is an industry with constantly shifting rules, regulations, rental rates and property values.

Yet we all know it to be true that real estate, when carefully and thoughtfully invested in, can be the foundation for true security, wealth, and a healthy return on investment. So how does one navigate this jungle of real estate investing? What do you look for and whom do you trust?

This report aims to give a comprehensive overview of how to shop for turnkey investment property, regardless of the market you're investing in. If you avoid the pitfalls outlined here and secure sellers, properties and management of the type discussed, you will be well on your way to being one of the success stories that attract people to this business in the first place.

Before making any investment decision, you should educate yourself as much as possible on the details and nuances of that investment. Another term for investigating and educating yourself about an investment is due diligence.

This report provides 18 due diligence questions that you *must* ask anyone you're considering purchasing turnkey investments from. More importantly, we provide all the details behind why you're asking these questions, and which answers signal a good deal... or a potential investment nightmare.

First, a basic definition so of what a true turnkey investment is:

A turnkey real estate investment is an income producing rental property that has been completely renovated and is cash flowing at the time of purchase, with a tenant and property management already in place.

Investing in turn key real estate is much like investing in the stock market. Your initial capital investment is made with the anticipation of future monies earned.

A true turn-key experience provides cash flow from the day of purchase, is entirely hands-off, and is a completely passive investment. You don't coordinate repairs or receive phone calls from tenants. You simply realize your monthly returns while building wealth through real estate.

My wish is for this report to provide you with a detailed understanding of turnkey real estate and to give you the confidence to pursue your goals in this field. If you have any questions feel free to drop me an email at [terry@midsouthhomebuyers.com](mailto:terry@midsouthhomebuyers.com) and I'll get back to you as soon as I can.

Ok here we go...

## **1) Are you the actual owner of the property or are you just marketing it for someone else? (You're trying to find out if you're talking to a middleman)**

When researching turnkey sellers, you'll find that many of them don't actually own the properties they're selling. They are simply marketing properties for others, acting as middlemen between you and the true owners. There's not anything necessarily wrong with this concept, but it's your job to try and find the direct source. Doing so cuts out all the fat and gives you the best possible return on your investment.

Finding the true owner can be tricky however, because middlemen are pros at disguising themselves as the actual owners of the properties they're selling. Not only that, they'll often insinuate they're principals of the management company that will be managing your property. Be careful you're not being referred to a management company that is one of their affiliates. If a seller refers to a person or company as one of their affiliates or partners in regards to the purchase, sale, renovation or management of a property, then you must know that the middleman has limited or no control over that aspect of your investment.

**If you buy a property from someone who doesn't own it, you're buying from a middle man. Most middlemen mark up the price of the properties they're marketing between \$5,000 and \$20,000. Your job is to find out who really owns the property you're interested in, and work the deal with them to the best of your ability.**

The essential thing to remember about a middleman is that you won't know you're dealing with one unless you know the right questions to ask.

Middlemen don't own the properties they're marketing and get paid 1 of 2 ways:

1. They get a large kick back from the true owner. A typical example: A seller wants \$50,000 for his property. A middleman comes along and says "Hi Mr. Owner, if I can bring you a buyer that will pay \$60,000 for your property, will you give me \$10,000 at closing?" Mr. Owner says "Sure, why not, what do I have to lose? I suck at marketing anyway." Mr. Middleman says, "Hey, do you mind if I take pictures of your property and put some details on my website?" ...you get the picture.

**Tip: Always Google the address of the property you're interested in. Find out if the property is listed anywhere else and who the true owner of record is.**

2. The second way middlemen make money is by finding cash flowing rental properties, putting them under contract with the owner, and marketing them at a higher price. Once they have a buyer on the hook, they do what's called a simultaneous closing. This means they purchase the property hours, if not minutes before you do, usually without your knowledge. The middleman makes a handsome profit and you've received no value from the increased sales price.

**Many reputable turnkey sellers pay referral bonuses to agents who bring buyers or clients who refer family and friends. In this instance the price of the property is not marked up and should not be confused with a middleman type transaction.**

Even though all middlemen are not dishonest, you should be on the lookout for misleading statements such as "We're so proud of our renovations" and "The quality of our property management is so high". While they may be marketing a quality product, they'll have to do so at a significant mark-up if they want to make money on the transaction themselves. You'll do much better if you purchase from the same source they do, the actual owner of the property.

## **2) How long have you been a full time turnkey investment provider?**

Typically the longer someone has been in business the better the business will operate. The main thing you want to be sure of is that your turnkey provider is a full-time professional. There is no way to run this type of business and hold down another job.

## **3) Have you ever lost any of your investment properties to foreclosure?**

I know asking someone if they've ever lost a property to foreclosure is a tough question to ask, but it's very important not to take advice or do business with someone who does not have a fundamental understanding of how to make this business work.

Do your homework. Ask sellers the tough questions, and then do your own research to verify their answers. This is your hard earned money we're talking about. Protect it.

Many investors bought properties before 2007 when rental properties could be bought and financed at 100% loan to value. Most of those investors are now bankrupt. Their down fall was over leveraging. They didn't simply buy their properties and put loans on them for the amount of their investment. They made a poor business decision and participated in what has rightly become the dirty word in banking nowadays. They did "cash-out refinances". A cash-out refinance is a type of loan in which the owner refinances a property they'd previously purchased. Upon closing on the refinance, they pulled "cash out" ultimately removing the equity from the property. This was bad for several reasons:

- 1) Because they pulled cash out on the refinance, they incurred more debt to service, which decreased their cash-flow.
- 2) All of the closing costs associated with the second closing were rolled into the amount of the new loan. This added even more debt to service, further diminishing cash-flow.
- 3) The owner now has an over-leveraged property that according to federal guidelines must now pay mortgage insurance as part of the monthly payment. This again further decreases cash-flow.
- 4) Cash out refinance loans received higher interest rates because they were riskier. Higher interest rates = higher monthly payments = less cash flow.

Investors kidded themselves into thinking the borrowed funds from the cash outs were profit and would float the negative cash-flow from their rentals. Because cash financing was easy to access, a lot of investors jumped on the bandwagon. They increased their lifestyles by doing as many of these as they could, and lived off the borrowed funds. When the music stopped and the cash out refinancing option was no longer available, a lot of investors found out the hard way that their business models were very flawed. Their properties didn't cash flow in the long term because they couldn't withstand the occasional vacancy and repair associated with investment property. The only way their business model could sustain itself was through continued cash outs with new acquisitions. Needless to say, investors with this business model ultimately met with financial disaster.

Most of these investors were never particularly good at renovating or managing property. They simply bought them, removed the equity with a cash-out refi, and handed their properties off to a third party management company.

Today, you'll find a lot of these same individuals posing as successful turnkey real estate investors. Most of them still don't renovate or manage property. Their forte is now just good marketing. Because they're no longer able to secure financing, they market other people's properties as their own, increasing the purchase price while rarely providing any additional value.

#### **4) How many rentals do you personally own?**

You want a turnkey seller that walks the walk, not just one that talks the talk. If a turnkey seller believes in the product they're selling, they will own a lot of rental properties themselves. Beware of the cook that doesn't eat his own cooking.

#### **5) I see that your business model is selling properties that are in distressed condition, promising a quality renovation after my purchase. How can I be sure the renovations will be done in a timely manner, with a high level of quality, and without going over budget?**

##### **BUYING DISTRESSED TURNKEY PROPERTY**

There are some turnkey sellers that specialize in selling distressed property promising renovation and management after your purchase. Although there are good deals out there that fit this description, they call for a lot more due diligence than purchasing property that has no deferred maintenance and is already cash flowing.

If you purchase a distressed property from a seller that promises a good renovation after you purchase, please get very serious on your due diligence. Unless you are a very seasoned pro, I suggest you spend a few hundred and hire an inspector to give you a detailed report on the condition of the property and an estimate of the cost of renovation. This is how I bought my very first house. Armed with the inspection report and an estimate of the cost to rehab the property, I revisited the seller with a much lower offer. I saved about \$10,000 and a lot of heartache.

#### **6) Since I can't get a 30 year mortgage on the unrenovated property you're selling, I'll have to borrow money from a private lender and then do a second closing once the property is habitable. What are the pros and cons of this type of transaction versus buying a property that is already renovated and cash-flowing?**

I'll admit that this is a loaded question because there's hardly any comparison between the two options. Without a doubt one of the biggest ways new or out of town investors get in trouble is by purchasing distressed, vacant property based on the seller's opinions of the following:

- A. The supposed condition of the property
- B. The hypothetical cost of renovation
- C. The proposed market rent

D. The estimated length of time between your purchase date and the day the property becomes occupied and cash-flowing

Even if you're dealing with an ethical seller, any of the above factors can easily incur overruns or not go as expected, costing you money and lowering your anticipated return on investment. If everything were to go exactly as projected, you're still looking at several months without cash flow and the risks associated with vacant property. See question 15 for more info on the dangers of vacant property. In addition, if you're borrowing money from a financial institution, you'll have two closings, consequently doubling your closing costs. In short, if you're going to buy distressed property outside of your own market, please be extremely careful and certainly don't compare it with a true turnkey investment.

## 7) What kind of guarantees do I have regarding the overall quality and depth of your renovations?

Look for a turnkey seller that offers a one year home warranty. If you're buying a property, *especially if you're from out of town*, this should not be negotiable. If your seller is not confident enough in their product to offer a home warranty, you should at the very least insist on a detailed home inspection from a third party inspector. Home inspections typically cost \$350-\$500 and are a must-have if your property does not come with a one year warranty. We highly recommend Amerispec Home Inspections, a national home warranty company. [www.amerispec.com](http://www.amerispec.com) 1-888-634-9861 for more information.

In question #12, we address the importance of your seller and property manager being one and the same, keeping all the accountability under one roof. Nothing is worse than finger pointing between the seller and property management company over repair and warranty issues.

## 8) I've noticed that there are properties in your city selling for \$120,000 with a \$300/month cash flow, and there are properties that are selling for \$200,000 with the same \$300/month cash flow. What are the pros and cons of these two different types of investments?

What you need to consider when comparing two investment properties with similar cash flows, but different purchase prices is this: **What ultimately determines your overall return is the cost of your initial investment combined with the cost of vacancies over the long term.**

I advise each and every investor I counsel to treat their investment property like a business. One aspect of this is understanding that at some point in the future, your property will experience turnover. In this graph, we compare a typical \$120,000 investment property with a typical \$200,000 investment property. You may be surprised by how two properties with identical gross cash flows have such a large variance in returns. **Notice how the difference in square footage and initial down payment drastically affect the return.**

## Cost of initial Investment

	Investment A	Investment B
	\$120,000 Purchase Price 1,200 Sq. Ft	\$200,000 Purchase Price 2,200 Sq. Ft.
25% down	\$30,000	\$50,000
Debt Service (Principal & Interest)	\$525.22	\$875.36
City & County Taxes	\$59	\$139
Insurance	\$37	\$80
Total Monthly Payment	\$621.22	\$1,094.36
Rent	\$1,025	\$1,550
Management Fee	\$103	\$155
<b>Cash Flow after Management</b>	<b>\$300.78</b>	<b>\$300.64</b>

## Cost of a 30 Day Vacancy

	Investment A	Investment B
	\$120,000 Purchase Price 1,200 Sq. Ft	\$200,000 Purchase Price 2,200 Sq. Ft.
Get Ready" & Repair Costs (\$0.85 x Sq. Ft.)	\$1,020	\$1,870
Total Monthly Payment	\$621.22	\$1,094.36
Utilities (\$0.16 x Sq. Ft.)	\$192	\$352
Total Vacancy Costs	\$1,833.22	\$3,316.36
<b>*Net Cash Flow after 24 months occupied, 1 month vacant</b>	<b>\$5,385.50</b>	<b>\$3,899</b>

\*This graph is based on 24 months of occupancy and 1 month of vacancy.

\*\*This graph assumes that all features and amenities are identical. However, the typical \$125k rental property will need to come with a stove, refrigerator, microwave, dish washer, garbage disposal, and often an automatic garage door opener. All of the above are maintenance-heavy items and are not offered in lower end rental property. Continued service of these items over the life of your investment will even further decrease your return on investment B, beyond what is shown here.

## Annual Return on Investment

	Investment A	Investment B
	\$120,000 Purchase Price 1,200 Sq. Ft	\$200,000 Purchase Price 2,200 Sq. Ft.
Cost of Initial Investment	\$30,000	\$50,000
Cash Flow After Vacancy	\$5,385.50	\$3,899
<b>*Annual ROI</b>	<b>8.9%</b>	<b>3.8%</b>

\*This Graph is based on 24 months of occupancy and 1 month of vacancy.

As you can see, identical cash flows do not create identical returns.

## 9) What type of neighborhoods are your properties in?

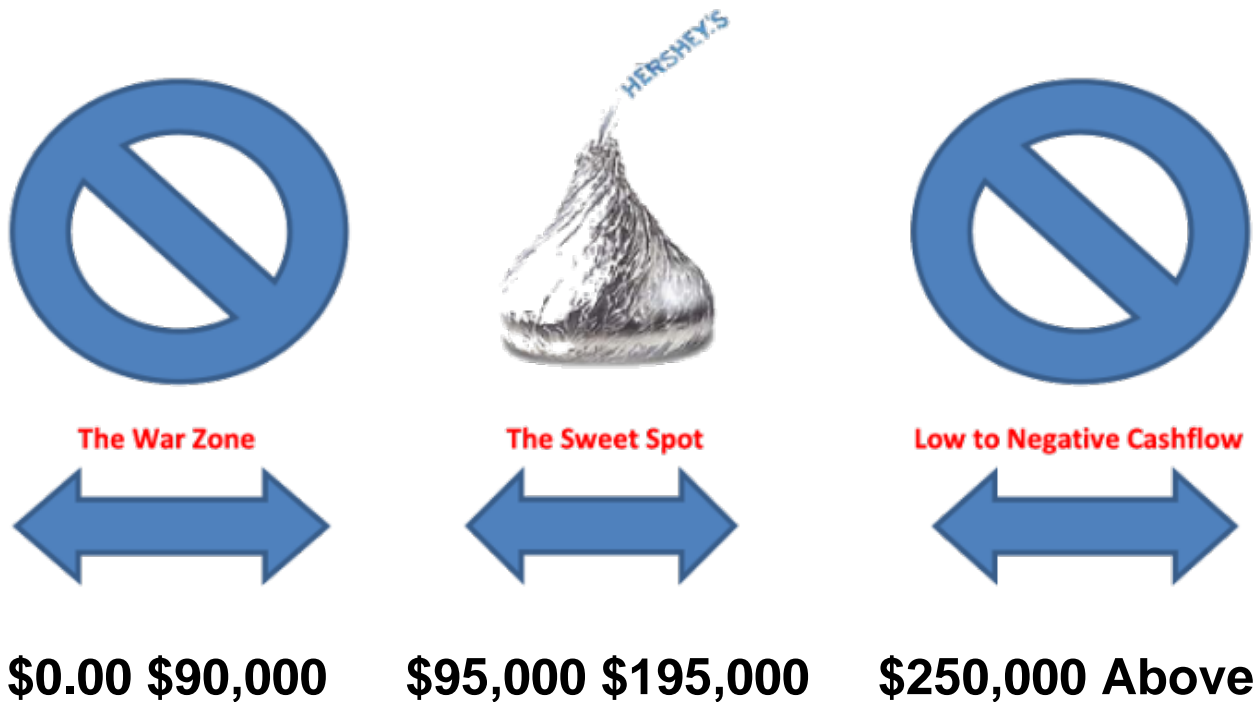
The main thing you are trying to discern is whether or not the properties are in what investors call the “war zone”. Different investors have different goals in regards to investment property. Some investors are more interested in long term appreciation, while others are looking for the highest cash flow possible. No matter what market you're interested in, all major cities will have neighborhoods you don't want to invest in, regardless of the price of the property. I've passed on property that was literally offered to me for free.

If one end of the property spectrum is the war zone, the other end is the million dollar neighborhoods. Neither of these neighborhoods tend to be desirable from an investment perspective. In the question above, we addressed how investors can get into trouble on the high end of the spectrum. The war zone is of course the low end of the spectrum. Somewhere in the middle is what we call the sweet spot.

**The sweet spot occurs when the relationship between purchase price and market rental rates produces the highest cash flow possible.**

The relationship between purchase price and market rental rates varies from city to city, and is one of the largest determining factors for how well your property will perform. It's your job to research and find the sweet spot in the market you want to invest in.





\*Values above based on the author's market. Sweet spots vary city by city.

## 10) Do you own the property management company that will be managing the property you're selling?

The answer needs to be yes. If it's not, keep looking. Besides the purchase price of your property, the quality of management is the number one factor for how well your investment performs.

A turnkey seller that also manages your property has a strong financial interest in making sure your investment performs long term. Long term performance increases the likely hood that you will become a repeat buyer and refer your friends and family. In contrast, third party property management companies benefit when your investment suffers, because they profit from maintenance and turnover.

The best performing properties experience positive returns because of the quality of the property, timely maintenance service, and accessibility to management. When dealing with separate sellers and managers, there is often finger pointing from seller to manager and back again in regards to faulty performance. Do yourself a favor and leave the accountability in one spot under the same roof.

Another small but distinct advantage of buying from a seller who owns the management company that will manage your investment, is that the maintenance will most likely be performed by the same crews

that performed the renovation. If this is the case, their familiarity with the property will eventually save you money on repairs down the road.

## **11) I know that the quality of the property management will ultimately determine how well my property performs. Tell me what your company will do to maximize the return on my investment?**

There is no way to overstate the importance property management plays in how well your investment will perform. Great deals can be managed into disaster with the wrong property management, and conversely, marginal deals can be managed to success, given enough time and quality management.

You should spend as much time and effort researching property management as you spend researching the property itself.

**Tenants are the lifeblood of any real estate investment business. If they don't pay the rent, the investment doesn't perform. Make sure your property management company treats them like gold.**

## **12) I see that 123 Maple Street is rented for \$725 per month. Is \$725 at, above, or below market rent?**

The best answer you can receive is that the property is rented at slightly below market rates. Keeping rents slightly below market increases the likely hood of a long term tenant. Vacancy, not slightly reduced rent, is the biggest killer of return on investment for rental property.

For example, if market rent for a property is \$725/month, it is wise to market and rent that property for \$675-\$700 per month. Although \$25-\$50 per month is not a lot of money to us investors, it is a lot of money to the tenant. This small difference, when combined with a rental that is in top condition, encourages lease renewals and will keep your property occupied and cash flowing for years to come. Utilizing this strategy will increase the return on your investment well above the additional \$25-\$50 per month you would have received in rent.

### 13) Is the property currently occupied?

**When shopping for turn-key real estate, don't compare vacant properties with occupied, cash-flowing investments. They're not apples to apples investments and should be valued accordingly.**

If you're considering purchasing a vacant property you should be aware of the many potential problems associated with this type of purchase. Some of the problems that accompany the purchase of vacant property are:

A) It's impossible to know how long the property will sit vacant before becoming occupied. Vacancies are the biggest killer of return on investment in real estate. It's a bummer to start your investment off with several months of vacancy, putting your ROI in the hole right from the start.

B) One of the biggest "gotchas" of purchasing vacant rental property is finding out market rental rates are significantly less than you were led to believe. Your decision to purchase was based on a cash flow that was unattainable. Regardless of whether or not the property you're about to purchase is vacant, you should check market rents to make sure the proposed rent of the subject property is on par for the area (or preferably slightly below. See question #14).

It's absolutely possible to rent a property at above market rates but the potential for lease renewal will be slight, drastically increasing your likelihood of vacancy and simultaneously reducing your return on investment.

Typically, the only reason a tenant will pay above market rent is because they are not able to rent elsewhere. Most tenants paying above market rent have worse than average credit, often times with multiple evictions. These are not the types of tenants you want in your home.

C) The potential for vandalism and theft increases exponentially when the property is vacant, regardless of the quality of the neighborhood.

D) Most landlord insurance policies have a 30 day vacancy clause. Unless you have a specific vacant property insurance policy, your property will be exposed to liability for fire, theft, vandalism, acts of God, etc.

If you're going to buy a vacant property, don't close unless you have a vacant insurance policy. Get ready for sticker shock. Vacant insurance policies cost up to four times as much as a regular landlord policy.

A true turnkey investment will provide instant cash flow from the day of closing and be free of the potential pitfalls associated with vacant property.

## 14) What is your occupancy rate?

This is one of the biggest indicators of how well a property management company is performing.

A good turnkey seller/manager will be able to tell you how many vacancies they currently have on their books without flinching, and more importantly their percentage of occupancy. Regardless of the answer, probe as to how they market, average length of vacancy, what their criteria is for occupancy, etc...

### SOAPBOX

**A turn-key seller/manager that truly endeavors to provide high quality investments that stand the test of time will have adopted this philosophy: *Performing a top-notch renovation and renting property at slightly below market rates attracts a higher-quality long-term tenant, ultimately increasing the return on investment.***

## 15) What is the longest vacancy currently on your books? (If they can't tell you, this should be a red flag)

If a property has been vacant longer than 45 days, there is a potential problem. You're trying to find out what the problem is. Is it a two bedroom and the market is for three bedrooms? Is it in an undesirable part of town? Find out what the problem is and make sure to avoid purchasing similar properties. Sometimes a property that has a special price also has a special problem.

## 16) Do you charge application fees to potential tenants?

You can't allow this question to be a deal breaker when you're shopping because unfortunately, the overwhelming majority of turnkey outfits are going to answer "Yes". This is because application fees are a huge profit center for management companies. However, if you're lucky enough to stumble across a management company that absorbs the cost of applications, you've found a good one.

A management company that absorbs the costs of screening applicants ensures that the maximum number of individuals will apply to rent your property. Having a larger pool of applicants to choose from allows them to select the absolute best tenant for your property. This type of management team is

focused on finding the best quality tenant, (the lifeblood of all real estate investments) not making money on application fees. This is the hallmark of an owner-focused management style.

### **17) Do you accept aggressive breed dogs?**

This is a sticky liability issue, and we are in no way real estate attorneys. However, in the opinion of the author, proper due diligence would include asking to see the lease the management company uses. If specific breeds aren't permitted, it will be stated in the lease. Do a little research and you'll find that other investors have had legal trouble over this issue.

### **18) When my property has a major repair or turn over, will you send me a video of the repairs needed?**

This is an especially important question for out of town investors and you should expect nothing less. HD recording options are now readily available, and any property management company worth its salt should offer this service to its investors.

If a picture is worth a thousand words, then a video is worth a million. There's nothing like a detailed video explanation to give you confidence and understanding of the work to be performed on your property. As the saying goes, locks keep honest people honest and video doesn't lie. Insist on it.

## About the Author...

In addition to being a husband and father of two, Terry Kerr is a full time real estate investor and the president and founder of Mid South Home Buyers. He owns 75+ investment properties and has provided premier turnkey investments to repeat buyers around the world since 2002.

He is also the owner and founder of Mid South Best Rentals, one of the most sought after management companies in the Memphis area and a key component of his turnkey investment business.

He loves to discuss all components of real estate investing with both seasoned and new investors. He genuinely welcomes your thoughts and questions, or if you have opposing points of view, your comments.

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