A Single's Game of Real Estate

(Getting started in your twenties)

By Dan Auito

This discussion leans toward answering questions asked most often by our youthful men and women in there early twenties. They often begin to ask themselves the question, "Should I consider buying a home, condo/town-home or some other type of real estate that I can call my own?" Due to the fact that housing has up to this point always been provided for or lived in on a rented basis we tend to find that our newest contributing members of society find themselves at a loss for the most beneficial and advantageous way to enter this next phase of self-sufficiency.

Due to the fact that most of us grow up in either a rented apartment or our parent's single family home, it stands to reason that most people, when beginning to ask themselves the question of purchasing their own dwelling, will come to the conclusion that a condo or small house is probably the way to go. That's a result of conditioning and it's a hard mindset to break! After taking the time to talk to or personally guide a respectable number of people in their twenties, I have come to find that firm, direct and accurate information can really adjust the reality of how real estate can be acquired and used to their best advantage starting with property that sets the tone for a much more profitable and rewarding future.

Everyone understands the concept of paying rent, so to begin with a great opening question to our real estate student is, "How would you like to collect that rent as opposed to pay it!" Naturally this question gets their attention and we can begin to open the door of enlightenment. I like to use the duplex example to illustrate the two homes under one roof concept. Some people are unfamiliar with what exactly a duplex is and how it works, so I simply state that quite often you find duplexes composed of one building that has two bedrooms and one bath on each side, all under one roof, some larger, some smaller.

These are as easy to finance as a single family home and in many cases allow you to qualify for a larger loan amount which leads to using leverage and more of other people's money to get ahead faster in life. Using an example lets say you find a duplex for $150,000 (California is higher), your loans interest rate is 6% that would cost **$899.33** a month to pay principle and interest back on a 30 year loan. They would have to insure it, so we use an average of $5 per $1000 of home value to average insurance costs. So $5.00 x $150.00 = $750.00 a year for insurance. We divide that by 12 months to get a figure of **$62.50** a month for insurance. We also have annual taxes that are based on what the home is worth multiplied by a millage, or mill rate. Let's use a tax rate of $11.00 per $1,000 of the homes assessed value: $11.00 x 150 = $1,650.00 a year. Now divide that by 12 months to get a monthly tax of **$137.50** and by adding principle, interest, taxes and insurance (P.I.T.I), we get a **total monthly mortgage payment of $1099.33.**

Now when you rent one side out for (in many cases, approximately $750.00 a month) you are left to pay only $349.33 out of your own pocket every month. When I get this point firmly affixed to the gray matter of their brain, it becomes clear that this amount is much

lower than the amount of rent they are now paying to live under someone else's roof and rules. Now the questions start coming in the following order. Well? How do I buy something like this? The answer most often begins with, "By getting **pre-qualified** for a loan," and I go on to say you will need to gather and bring the following things to the bank loan officer to get started:

1. Copies of three years of tax returns for first time buyers + schedules and W2 forms
2. Copies of most recent pay stubs within the last 30 days
3. Copies of your most recent three months of bank statements
4. A list of all creditors with name, address and account numbers

With these initial documents the lender can begin to process your application for a loan. They will determine your assets and liabilities (net worth) as well as verify where you live now, your credit history and a host of other information that begins to validate your existence and ability to borrow money now and in the future.

Once they've had a chance to review and verify your information they can pre-approve you for a certain loan amount. Once your approved you can begin your search for a home of your own, typically as a first time home buyer you will find that there are programs that let you put as little as 3-5% percent down in order to buy a home that satisfies the lender's guidelines according to its value and conformity. Now on a $150,000 loan the down payment can be anywhere from $4500.00 - $7500.00.

There are ways to lower these costs and a great place to start is by attending a **first time home buyer's class.** These classes introduce you to the basics and give you further information on programs that are currently available that may offer you the opportunity to buy with nothing down! So with that said, the next step is to get to a free class and get familiar with the process. Often I recommend going to the class before going to see a lender so you don't appear so green and unprepared upon your initial introduction.

Since I usually find these poor souls wondering and wandering in the land of the lost, the next frown I see come over them is the realization that they just don't have the money required to start. So the question comes up as to where to get it. I usually ask about savings, whether parents or grandparents can help, if they can sell valuable possessions or take second jobs, get grants, gifts, use trust funds, personal loans or co-signers, or a combination of these alternatives with a complimentary loan program usually gets the ball rolling. Options and hard money lenders usually come later as alternative funding and acquisition sources, so I won't confuse any one with those now.

The bottom line is this: If someone wants something bad enough there is always a way!
The nice thing about duplexes is that the lender will take into account the fact that 75% of the rental income from the other side of the property can be used to offset your qualifying ratios, so in this case they can use 75% of the rentals $750.00 income to reduce the amount you must earn to qualify for what appears to be an unaffordable loan. Seventy-five percent of $750.00 equals $562.50. Now subtracting that amount from the original

mortgage payment of $1099.33 leaves you with a payment of $536.83 which the bank says you must be able to repay every month out of your own pocket. You can do this!

Can you begin to see how with a little information, effort and belief you can actually own something and pay less than what you are currently paying in rent?

Let's continue on with the way things begin to unfold once you begin the journey. Starting with the day you close the deal and become the new owner you will see that you now have just created a passive income stream that gives you an extra $750.00 a month without you having to punch a clock or trade a certain amount of hours to earn the money. Your new asset works for you day in and day out constantly generating income for you while you go and do other things. This is leveraging your time and money in a very beneficial way!

You also will notice that at the closing of your purchase that the old owners who sold you this property had to prorate or give you a share of the rents due and any security deposits that the tenants had given to them. Now add to that the likelihood that your first house payment won't come due until about a month and a half after you move in and you find yourself with, low and behold, *extra money,* probably for the first time in quite a while!

Let's calculate it using **simple math.** Assuming you close on the 15th of the month, you will have 45 days before your first payment comes due, you will be credited with 15 days of rent, you will receive all security deposits of the tenant and you will receive another month's rent on the first of the month from your tenant and you yourself will have no rent or house payment of your own to make for another whole month. What does all that add up to? Let's break it down:

1. Fifteen days of rent equal to $375.00
2. A half month's rent as a security deposit equal to $375.00
3. A full month's rent in another 15 days equal to $750.00
4. No payment to the bank for another 30 days and you're not paying rent to anyone any longer, so you keep whatever you normally would have had to give to someone else as rent that month (let's say that was $500.00).
5. Another payment to you for $750.00 from your tenant as well as you having to make your first mortgage payment of $1099.33 on the 1st of the month which comes 45 days later.

Side note: If you decided to rent your second bedroom to a roommate, they would pay $500.00 a month and half your utilities as well, thus your basically living and owning this property for free. Say goodbye to all those student loans as you divert all these freed up funds to pay off loans instead of a landlord!

Adding these up, we get $375.00 + $375.00 + $750.00 + $750.00 + 500.00 not paid to your old landlord. That equals $2,750.00 that you will now have as a result of your first

month and a half of ownership. Now subtract your mortgage payment of $1099.33 and you are left with a reserve fund of $1,650.67 in your account. Take your parents out to a steak dinner and celebrate - you've earned it!

Let's review: You decided to buy your own home, you made the choice early to offset expenses by looking at a multiple income property, you went to the homebuyer's class, you went to see a lender and got pre-approved for a loan, you saved or arranged to have the necessary amount required to buy and you hunted, searched and analyzed more than a few properties in order to find a good one that would satisfy your criteria.

Your next phase is to begin to realize that you are now **responsible** for the welfare of another family or person due to your willingness to become a landlord. Your tenants pay rent and expect you to take care of their housing needs. If you chose a good property by carefully looking at plumbing, heating & A/C, electrical, foundation, structure, roof, location and price, then you should be well positioned to be able to successfully manage these duties. Often, you as the new owner will begin to make improvements to the property such as painting, installing new carpet and doing some inexpensive landscaping and repairs. These are the things that add value to your property and keep your tenants happy while at the same time not breaking the bank!

With $1,650.67 in your bank account, you're not exactly Donald Trump just yet, but you're getting there! Smart landlords **establish 6 month reserve accounts** and/or **contingency funds**, which protect them in times of *vacancies* or when expensive unforeseen *repair bills* pop up in addition to regular planned-for maintenance items. What I'm saying is don't spend your reserves frivolously. In my case, a steak dinner is a tradition but the major portion of your funds should only be used to build, protect and enhance your asset's ability to produce and sustain income generation.

By taking on responsibility in the housing market at such a young age, you will have some added benefits and opportunities coming to you. Let's look at what starts happening: the first thing is you have overcome fear and lack of understanding by acquiring your first property. In addition, you have begun to offset expenses while saving more money, you are establishing excellent credit while building assets, and you're gaining tax advantages while getting management, home buying and repair education at an early age. These are outstanding life skills that you can employ for the rest of your life and the longer the period of time that you have to use them, the further the compounding effects will help you to go.

This type of initial home-buying strategy can and does lead to further opportunities to grow and achieve further benefits besides those already mentioned. Individuals who learn to accept responsibility early will by nature grow more mature throughout the process and in effect create for themselves a higher status in the minds of others by being looked upon as a current homeowner and landlord. Once established, you will become known for what you can do. If you were single when you undertook these challenges, then you will appear and become more self-sufficient to the opposite sex.

What do I mean by that? What I'm saying is when you meet someone who may become your spouse in the future, they will recognize your ability to provide for their safety and protection and they won't question or complain about your fooling around with wild ideas of becoming educated in real estate now. They will accept that this is something you do and will respect your ability to manage this part of your life.

As time passes on and you find this love of your life and the eventual marriage proposal ensues, the time will come when you're going to want to ***separate business from pleasure.*** As a young couple the time will come when you may want to start a family or at least separate yourself from your tenants while moving up to a nicer single family home that suits your changing needs more appropriately. Perfect, because now is the time to consider renting out both sides of the duplex while you begin to investigate your new single family home.

How does this phase work? Hold on, I'm getting there! Okay, let's assume its two years later and you have been living in and improving your duplex all along. Now taking into account that you bought a decent property in a good neighborhood and inflation and appreciation has been adding value in addition to your improvements, your $150,000 duplex should command a new appraised value of $175,000. Let me explain how the value grows: 3% annual inflation multiplied by $150,000 equals $4500.00 the first year. Let's also say that appreciation due to demand also adds 5%, so 5% x $150,000 equals $7500.00. Now $150,000 + $7500 + $4500 = $162,000, which represents the new value for year one. The second year we do the same math on $162,000 and we get $12,960 for year two. Adding that to $162,000 equals $174,960. Okay, I was off by $40.00. Don't forget any improvements and that you may have bought it at a discount because the old owners where motivated and you might find its worth even more.

Now over those two years you have also been paying that old mortgage of $1099.33 each month and the principle amount that you owe on your loan has been reduced by an additional $3,965.96, leaving you with a loan balance of $146,034.04. The difference between the new appraised value of $175,000 and the current amount of $146,034.04 which you owe equals $28,965.96. This number represents the equity, or value, that you currently own in the home. Knowing this, it is entirely possible to apply for and receive a home equity line of credit up to the full value of the new appraisal! If you haven't gone overboard on buying cars, boats and running up other revolving debt while at the same time your significant other or spouse-to-be has a job and good credit with manageable debt, than the bank is going to approve this line of owner-occupied credit.

Now what you have done is set up a line of credit which can be used to buy a $145,000 single family home with a 20% down payment. This allows you to avoid paying private mortgage insurance (PMI), thereby creating a very affordable new mortgage on your new family residence.

NOTE: Do not confuse homeowner's insurance with private mortgage insurance. PMI protects the lender while homeowner's insurance protects you. When you put down 20%

of value on a home's purchase in the form of a down payment, you are in effect protecting the lender from yourself because if they foreclosed on you for non-payment, they could sell the home fast for less than full value and still be paid in full.

Don't pay for private mortgage insurance if you can avoid it!

Let's not forget that as the value of your duplex has risen the rents should also be increasing along the same lines. Now instead of $750.00, you should reasonably expect to get $800.00 per month, per side, which now delivers $1600.00 a month to your bank account. Unfortunately you still have to pay for 28 more years on the original loan amount, so you will make that good old $1099.33 payment as usual. That leaves you with $500.67 left over to pay that new equity line back with. Your new $29,000 equity line which you used as a down payment on your new home costs you $336.71 @ 7% for 10 years. Now $500.36 minus $336.71 leaves you with $163.96 left over to maintain a nice little reserve account for vacancies and maintenance/repairs. This is a good example of how to transition to a secure lifestyle while using your existing asset base to buy more.

Review:

1. Break the mold and look at multiple income property to start.
2. Go to a first time home buyer class to get ready.
3. Go to a lender prepared to qualify for an affordable loan amount.
4. Focus your effort on learning how real estate works.
5. Realize the sooner you start, the better off you will be.
6. Offset expenses by renting to others.
7. Manage tenants, deposits and property responsibly.
8. Plan for the future using assets and equity lines to start.
9. Keep reading and learning how to do new things with real estate.
10. Find mentors and use knowledgeable people to help you along the way.

I hope this little plan of entering into homeownership has given you some ideas in your quest for independence. *Wishing you all the best! Your investment pal, Dan*

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