

# INVESTMENTS:

## House Flipping

### WHY IT'S NOT FOR ME, AND WHY IT MAY NOT BE FOR YOU, EITHER PART I OF 2

#### Was Watching a "House Flippers" Show Recently...

Not long ago, I was spending some time in a waiting room. With some free time on my hands, I watched one of those "house flipper" shows was on the TV. I hadn't watched these shows much before. After a few viewings since, I am convinced that the producers of these shows may really be flipping houses, but they are filling their shows with misinformation to put any would-be competitors out of business immediately. A few of the lines I thought were real funny were: "Let's put new sod and a sprinkler system in the front and

back yards – that should cost \$500," and "we need to completely gut this kitchen, move some walls around, and start over. That should cost \$3,000." Yeah – right.

#### What Do "House Flippers" Do?

House flippers are looking to buy a house then turn around and sell it as quick as possible for a profit. Since real estate is a relatively efficient market, this means that a house is worth whatever you can find somebody to pay you for it. It isn't reasonable, therefore, to expect that I could buy a house

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today and sell it next month for more money without doing something to add value to the house.

Adding value is what house flippers specialize in. A flipper will seek a house that needs value added to it – it's worn down and needs some renovations. He will buy the house and plan his renovations – in effect betting that he can raise the value of this house by more than what he puts into it.

This is tough to do. Many studies show that home renovations won't add even an equivalent amount of value to a home:<sup>1</sup> \$50,000 spent renovating the kitchen probably won't add \$50,000 of value. A house flipper needs to plan carefully to control expenses and preserve profit potential in the house.

## My Experience in Construction

I am a veteran of several major remodeling projects – both on rental properties and my own home. Every time I complete one of these, I swear to myself that I'll never do one again. I usually end up right back in the middle of one within a few years, however. (I just completed the final details of my latest project last week. This time I really want to mean it when I say "I'm done.") Of the many reasons that I dislike construction projects, the four largest are:

- 1. Nothing but details.** What style of crown moulding will you use? Buy the light fixtures, towel bars, faucets, tile, grout, backsplash, baseboards, cabinets, sinks and appliances. If you dislike shopping as much as I do, it's enough to drive you crazy. The costs of just these supplies tend to add up at an astronomical rate, as well.
- 2. Something always goes wrong.** This goes back to "details." With so many of them, something is bound to go wrong. When it does – it's going to cost you money.
- 3. Nothing ever happens on schedule.** As I mentioned earlier – I just finished a construction project yesterday. I started this project over one year ago. The project was expected to take 4 months. We were 80% done at 6 months, 90% done at 8 months, and completely finished with

all the minor details (including some things we discovered needed to be done) at 12 months. Again – details. This scheduling problem is especially painful to house flippers: Earning \$45,000 profit in 1 month isn't too bad. If you don't sell the house for 12 months, that's not too good.

## 4. When things slow down, contractors have problems keeping their staff around.

Successful contractors and house flippers have a good network of employees who are available to them on demand. This means that the contractors must have a steady supply of work for these employees. As a house flipper, you'll need your own staff to keep costs down. If you don't have work for these employees every day, though – they are going to look for work to fill the gaps in their schedules. The best workers will often find someone who can fill every day in their schedule – and that takes them away from you. A house flipper with no workers of his own may need to hire a contractor – and that's just another person that needs to get paid before a profit is made.

## We'll Talk More About This Next Month.

Once again, I have found a topic about which I have much more to say than my columns' space will allow. We will need to break this article up in to two months, as well. Next month, we will review data on how much money house flippers make, and the types of risks that they need to take in order to do so. As always, I can be reached with any questions at (877) 313-1868.

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<sup>1</sup> U.S. News & World Report, March 7, 2014. <http://money.usnews.com/money/personal-finance/articles/2014/03/06/which-home-remodeling-projects-are-worth-your-money>



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## House Flipping

### WHY IT'S NOT FOR ME, AND WHY IT MAY NOT BE FOR YOU, EITHER PART 2 OF 2

**A**s I stated last month, I was watching a house flipping “reality TV” show in a waiting room recently and wanted to write about that little segment of our industry. Last month was part one of this series, and we are concluding with part 2 this month.

I am always a bit amazed that people will choose to be house flippers. I have some experience with construction projects – always with my own money – and doing that sort of thing for a living seems like an awfully hard job. There are really easier ways to make a living out there. If I wanted

to work on houses for a living, I’d be a contractor instead of a house flipper – that way, I would be using someone else’s money to work on properties and I’d get paid to solve the expensive hidden problems that always seem to come up.

#### **How Much Money are House Flippers Making? The Statistics are Blurry**

I have noticed house flippers in my neighborhood operating on thin margins – some, in fact, had to have lost money on some of the homes. I turned to the internet in search of some hard num-

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bers, but was unable to find any reliable data. I did find surveys on sites like redfin.com, but these surveys did not adjust for property price – thus generating results that weren't useful for making any kind of comparisons. For example, they may take a \$500,000 home that flipped for \$575,000, a \$1,000,000 home that flipped for \$1,100,000 and a \$3,000,000 home that flipped for \$3,400,000. From that data, they can say that “the average gross profit for a house flipper in Los Angeles is \$191,000,” but you'll notice that doesn't accurately describe any of the examples.

My conclusion is that house flippers who are successful are, wisely, keeping this info to themselves. House flippers who aren't successful, on the other hand, can spend their time making tv shows about it or by charging \$2,000 for their “10 point plan to becoming a house flipping millionaire.” After all, either of those ventures offers much less risk than really flipping houses.

### **Evaluating the Market – and Your Risk**

When reliable hard data can't be found, inves-

tor must create their own examples and use them to test some financial projections. Our house flipping opportunity example is in a neighborhood where homes are selling for around \$550,000, and a run-down house with significant deferred maintenance, (“deferred maintenance” is often a term for “the owner ignored the leaking roof for 10 years and the 50 year old home is still wearing what is left of its original paint”), is available for \$450,000. At “market contractor prices,” perhaps \$100,000 would bring this house back up to the level the rest of the neighborhood is at. That, of course, puts our total cost at the neighborhood average, and could severely hinder our ability to make a profit. Remember, too, that you'll need to pay a real estate broker 6% to sell the property. That is a \$33,000 expense on a \$550,000 sales price.

This is where the tough work comes in, and where the successful home flippers earn their income. How can you do that \$100,000 of work for cheaper? On that house flipper show I saw, the presenter said “we need to install sprinklers and new sod in this front and rear yard – that's \$500, and completely gutting and renovating the kitchen

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with new appliances will be \$2,500.” If you don’t know how far off those estimates are, you shouldn’t even think of flipping houses.

Let’s say that you can cut your renovation costs in half to \$50,000 and were able to sell the house for \$565,000. This puts your total cost at \$450,000 + \$50,000 + \$33,900 = \$533,900. This will leave you \$31,100 of profit. I think that 6 months closing- to- closing is a very aggressive assumption, but let’s use that for this illustration. In 6 months, you have earned \$31,100 extra and have probably realized that home renovations is not the part time job that you thought it was. After you pay income taxes on that \$31,100, the amount that shows up in your pocket is much smaller.

To earn this \$31,100, you risked \$450,000 to buy the house, (even if you borrowed it, you still are risking that money – your lender will want to be paid back), and \$50,000 of renovation costs. That is a 6.1% return on your money in 12 months, or 12.2% annually. That 12.2% sounds inviting – but that’s before considering all the hard work to get it.

## A Hard Way to Make a Living

With all the “House Flipping” TV shows and “How to Become a House Flipping Millionaire” ads that I see, I just couldn’t go any longer without writing an article about it. Sure – you can make a living flipping houses, but it’s an awfully hard job with substantial risks. We got into real estate investing to make our money work for us; not so that we can work harder for money.

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