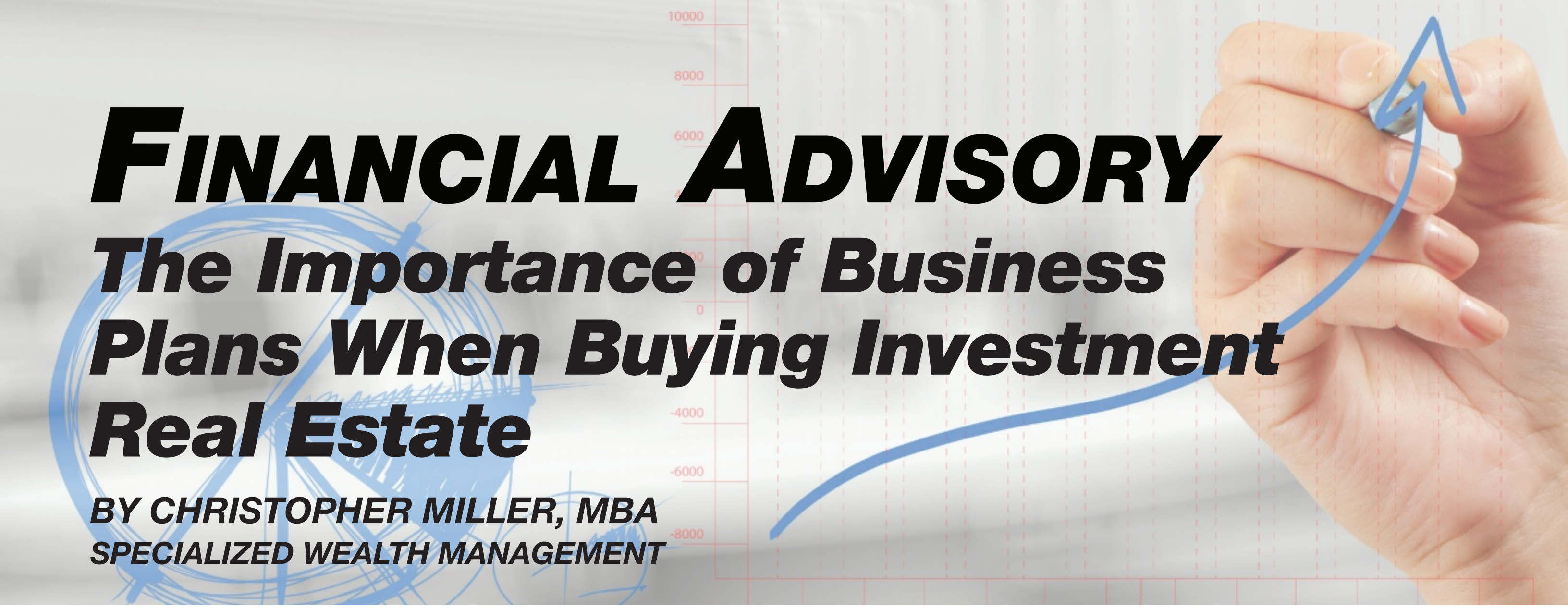

Financial Advisory

The Importance of Business Plans When Buying Investment Real Estate

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I can't believe that it is December of 2022 already! This month, I'll talk about business plans for your investment properties. The importance of creating a business plan for investment real estate does not get much press. I have seen that some people who deal with real estate for a living do not even use them. Whether you are a sophisticated real estate investor or only own one rental property, spending a little time on a business plan can save a lot of headaches in the future.

I have had this exact conversation with several real estate brokers over the past two decades:

> Chris: "While reviewing this property, I noticed that the lease runs for 75 years, and has no rent increases. How could I expect to sell this property for a profit?"
>
> Broker: "Real estate always goes up in value, right?"

Wrong! I have always reminded my investors that real estate's value is tied to the income it produces. Rising income is needed to realize rising property values. At the same time, flat income does not lead to stable value. In fact, due to the influence of inflation, it leads to declining value over the years. Why buy real estate that will slowly decline in value over the next 50 years? People do every day. These investors do not mean to do that but, because they lack a business plan; that is exactly what happens.

WHAT IS THE WORST THAT CAN HAPPEN?

Perhaps you have heard the phrase "People do not plan to fail; they fail to plan." This is exactly what happens often in real estate.

Our last financial crisis, about 14 years ago now, provided many examples: An investor bought a property for "a good price," but loses it to the bank 2 years later. Often, this happens due to poor planning. We have all heard of investors who bought single family homes with no money down and experienced a bad result. They bought a new home in what was formerly a desert for a "low price" of $400,000, taking advantage of "great financing" at 1.5% annually. With a $1,380 mortgage payment and $1,800 of monthly income, the investor figures he can't lose. But what happens when the special interest rate ends? The investor may have used an aggressive assumption like "the property will appreciate at 30% per year." His plan was to sell at that point and "cash in."

We all know what happened with that investment. When the interest rate kicked up to 6.5%, the mortgage payment became $2,528 per month, and the property's value declined to below $250,000. The investor found that his "can't lose investment" just did.

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Any good business plan contains provisions for “what if” scenarios. What if rents do not rise as fast as I expect? What if I can’t refinance? What if I need to hold the property for several years longer than I expect? Had the investor mentioned above asked these questions in a well-thought-out business plan, he could have saved himself a lot of trouble.

HOW TO CONSTRUCT A BUSINESS PLAN

A business plan can be summarized as follows; Put on paper what you want to happen, what you think will happen, and some things that might happen. Estimate the financial implications of these situations and write those numbers down. Next, write down your estimated expenses. (Mortgage, utilities, insurance, etc.) Create a spreadsheet that can test these scenarios. If you are “not a computer wizard,” this can be done on paper with a calculator.

When I started my real estate advisory business, I sat down to write a business plan. This plan contained my goals, my likely scenario, and my worst-case scenario. I reviewed the numbers of each, adjusted the plan as necessary, and moved forward.

I do this same thing when I buy real estate for myself or for my clients. We will estimate what rents and expenses will be, and then test that model with some “worst case scenarios. I always want to be comfortable with that worst-case scenario before moving forward.

REALISTIC FINANCIAL ESTIMATIONS ARE IMPORTANT

Assuming that an office building will go from 30% to 95% occupancy in 1 year or planning to raise rents 10% every year for 7 years may give you attractive numbers. In the absence of a special circumstance, neither of these business plans are very realistic. One can torture numbers long enough to tell a great story; but that does not make it true. Aggressive assumptions are best described as the ones least likely to happen. I prefer conservative business plans where things are nearly as likely to go better as they are to go worse than expected. After all, unforeseen things will always happen. It is good to have room in your plan for such occurrences. A conservative plan can absorb an unexpected repair bill, while that expense may kill the whole deal if your numbers are too aggressive.

WHAT I LOOK FOR

When I evaluate a property, I will look at the “full picture” and use that to put together some projections. By evaluating the building itself, its’ location, the surrounding market and submarket along with the leases and tenants, I can put together some financial projections. If these projections look attractive, and pass several “stress tests,” I will move on to looking at the business plan – how the property will be managed, and when it may be sold for a profit.

Every public company today has a business plan that identifies corporate goals and maps out a plan on how to get there. Doesn’t your real estate deserve a professional approach as well?

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