# 5 Pros and Pitfalls Investors Face When Jumping Into Residential Real Estate

in Daily Dose, Featured, Print Features January 12, 2018 0

*This select print feature originally appeared in the January issue of* MReport*, available now.*

We are living in an era of self-driving cars and artificial intelligence. The political climate is strenuous, but the stock markets are hitting record highs. Yet, through these technological advancements and unpredictable environments, residential real estate continues to be one of the most stable and attractive investments. While most markets see commercial and large multifamily cap rates in the low single digits, single-family and small multi-family investment property in certain markets offer the chance to double and even triple those rates of return. Consequently, investors of all sizes are riding this wave and seeking to jump-start or further expand their portfolios. The following tips will help you guide your clients in this space:

*Benefit Analysis:*

**Top 5 Reasons to Invest in Residential Real Estate**

**Range of Assets**

Within the residential real estate spectrum, there are a range of assets and property types available to investors. This asset class is mainly driven by single-family residences, or SFRs, as they account for over 11 percent of the U.S. housing market and roughly 30 percent of total rental housing. A broad definition of SFRs includes condominiums, townhouses, and small multi-family units. There are even sub types within residential real estate. For example, residential properties can be classified as either luxury or affordable housing, both of which have their distinct advantages and can provide a stable income stream. Residential real estate also provides investors with the opportunity to own multiple properties at scale, such as a portfolio of SFRs across different cities, counties, or even states. Investors can manage their portfolio to match their budget, goals, knowledge, and strengths.

**Flexibility and Ease of Ownership**

When compared to other investments, residential real estate is unique in the fact that it strikes an ideal balance between flexibility and ease of ownership. For flexibility, property owners can be hands-on with their investment, make repairs, and add tangible value whenever they deem fit. Inversely, they can also choose to take a passive approach and hire third parties to manage their assets at a lower cost and much less complexity than a commercial asset, for example. In terms of ease of ownership, residential assets typically require much less capital in order to operate. During operation, residential properties face less liability because they are not in the public eye and do not serve patrons, unlike commercial properties. Residential lease terms are more straightforward due to simple lease structures, therefore making it easier to find tenants. This ease of ownership makes the buy-and-hold strategy very attractive, as investors can increase their equity while receiving residual income.

**High Liquidity**

Unlike their commercial counterpart, the market for residential real estate is more liquid. Typically, it is much easier to bring a residential asset to market than it is to sell an office building or retail center. Furthermore, the purchase of a residential property, say a townhome, is much less complicated than the purchase of a commercial property. Currently, there are more than 326 million people in the United States. That number increases every day, and thus, creates an everlasting market for residential real estate. This liquidity gives assurance to hesitant investors and confidence to those especially focused on the fix-and-flip strategy.

**High Rental Demand**

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The rental market has been on a steady rise. In fact, it is at an all-time high and shows no sign of slowing down. Conversely, home ownership is losing its appeal. People do not necessarily associate buying a home with the American Dream, and demand for home ownership is at an all-time low at 63 percent, per the U.S. Census. In general, we are experiencing a large demographic and ideological shift in relation to homeownership. The new working class, especially millennials, value flexibility in their occupation and change jobs more frequently. They don't see a need to own a home and do not want to be locked into a traditional 30-year mortgage.

**Availability of Financing**

Debt can have a negative connotation and can intimidate potential investors. However, using debt to finance the acquisitions of residential investment properties is a great tool. Being able to leverage acquisitions dramatically increases the investor's purchasing power, and allows the investor to expand their portfolio with ease. Another great option is the ability to refinance. Refinancing an asset or a portfolio's debt enables the investor to realize any appreciation, and thus, use their additional proceeds to purchase more assets and expand their portfolio. Specialty lenders offer a large range of long-term and short-term loan products for residential real estate investors to refinance, acquire, fix and flip, or buy and hold.

*Learning From The Pros:*

**5 Common Pitfalls to Avoid**

While there are clear benefits as illustrated above, investors in the SFR market, as in any market, should take caution and build a clear offensive and defensive strategy. Make sure your investor clients are aware of these five common pitfalls in owning single-family real estate and their fixes:

**Overimproving a Rental Property**

It's tempting for investors who buy their first investment property to let their inner Martha Stewart out in every aspect—new floors here, new cabinets and granite over there. However, it's important for them to be careful not to overspend when renovating their properties. Whether it's the client's first house or their hundredth, it's important for them to look at the market comps to see what improvements are needed, and more importantly, not needed in order to compete for tenants. Keep in mind that rental investors are not looking to resell their property, and the things that buyers look for (new appliances, expensive flooring, nice fixtures) may not be the things that lure potential tenants. Investors should learn to salvage what they can while still bringing in light and using inconspicuous colors that appeal to the masses. Having said that, underimproving a property can also cause big headaches down the road. Investors should be careful not to confuse additional improvements with much needed capital expenditures—items that if not repaired now could cost significantly more in the future overall.

**Not Doing Their Insurance Homework**

Sure, the affordable home in Tampa, Florida, looks like an easy investment. It's got solid rent potential and a price point that seems too good to be true. But have your clients done their research on the property insurance that is recommended for the home? Some investors pay cash or obtain private/hard money financing to acquire homes. These scenarios often have relaxed requirements on insurance coverage, but also come with its risks. While the temptation to "self-insure" seems like a lock to generate even more yield on investment, investors should be careful in considering the downsides of not having proper coverage. Flood zones exist for a reason—because their house could succumb to a flood. Hurricanes are a real threat. The cost of proper coverage is something that needs to be factored into every purchase they make. Investors should not cut corners and ignore these important safeguards for their property.

**Insufficient Title Searches**

Most investors know and work with title companies that help them diagnose a property's legal health. While most title companies do basic searches, not all of them go above and beyond to find all the issues that could arise within the ownership of the home. Investors should ask the title company to run city and municipal lien searches in addition to their normal searches. There can often be unrecorded items outstanding that don't show up on your initial owner's policy. Typical title policies often exclude these from their coverage, leaving the potential damages on the shoulder of investors. Remind them to look for a national title company and an experienced SFR rental title insurer to provide them with deeper and more comprehensive searches.

**Apprehension to Invest in New Markets**

It's understandable that as real estate investors, your clients may look for opportunities only in their hometown. It makes sense, right? They know the neighborhoods, they can do their own repairs, they can meet with and filter all their tenants. While these are all positive things, they shouldn't get trapped into thinking their local market is the only place where good investments exist. In fact, they may find out that the city just down the road generates even higher yields than their hometown. With technology and the internet, the inventory of potential investments is at their fingertips 24/7. Property management companies have also become experts at managing disparate assets spread across different neighborhoods. Remind your clients of the options. Don't let them leave the blinders on; help them expand their target markets and see how owning homes in different locations than they are used to can prove to be excellent investments as well.

**Not Understanding Financing Options**

Real estate investing is a game of scale. The more properties investors own, the more they mitigate potential challenges such as vacancy and bad tenants. But in order to scale properly, it's important for them to consider using leverage. With the right lender and terms, financing can boost their returns and elevate their businesses to the next level. However, they shouldn't trust just any bank or hard-money lender.

Remind them to do their homework and find a private lender that excels and specializes in SFR rentals. Banks can be difficult (or impossible at times) to work with, and hard-money lenders can be very expensive.

By knowing and understanding both the benefits and challenges to investing in real estate before diving in, your clients will save time, money, and headaches down the road. As Zillow recently reported, the number of single-family homes that are rented grew by 5 million between 2006 and early 2017, so expect more clients to get into this investment space.



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About Author: Dennis Spivey

Dennis Spivey is VP at CoreVest, the leading lender to residential real estate investors nationwide. He has more than 13 years' experience in loan origination and finance, both in the retail and wholesale mortgage channels. Spivey began his career at Countrywide where he rose to become a Top 5 Account Executive. Later at Prospect Mortgage, he earned President's Club status within a year. His collective experience has helped him gain extensive knowledge in appraisals, valuation, underwriting, capital markets, and mortgage origination management. Spivey graduated cum laude from Pepperdine University in 2003 with a degree in business administration. To reach Spivey, visit CoreVestFinance.com.

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