House-Flipping How-Tos

If you know your market and you can stomach the risk, there's still money to be made

BY SEAN GROOM

Before the Great Recession, making money in real estate seemed like such a straightforward equation that it was too good of an opportunity to pass up—just buy a house, wait a few months for prices to appreciate, and then sell the house for a profit. Between 2000 and 2006, house prices in the four hottest markets—Washington, D.C., Los Angeles, Miami, and San Diego—rose 150%. Purchasing houses in dire shape, then remodeling and reselling them commonly offered even greater returns.

House flipping quickly evolved from a side hustle to a profession to the subject of reality TV shows. By 2006, flips accounted for about 8.6% of home sales nationwide, and in hot real-estate markets like Washington, D.C. and Chicago they were about 20% of sales. Let's call this period of house flipping version 1.0.

We all know how the story played out. After years of home prices ratcheting upwards, they began to plateau in 2006, and it wasn't long before the real-estate market resembled a collapsing Ponzi scheme. Without the benefits of instant equity and a highly liquid market, property owners with balloon-payment loans or adjustable-rate mortgages defaulted in large enough numbers to bring everything crashing down in 2008. While the decline in the 20 largest markets averaged more than 30%, in the hardest-hit markets, like Las Vegas, prices fell 60%. When the market bottomed out in 2008, investors started grabbing distressed houses at steep discounts. In 2012, comparatively slower but steady price increases began on a national scale, supporting a new, healthy flipping market—version 2.0.

Today, prices in a majority of real-estate markets have rebounded to at least pre-2008-crash levels. Combine the increased prices with a relatively low inventory of houses for sale, and owner/occupant buyers have been dipping deeper into the low end of the market, taking on repair and upgrading projects themselves. Plus, the most obvious flip-worthy houses have been snapped up over the last decade as new investors continue to crowd into the market. With narrow profit margins, investors need to have a solid business plan and they must be disciplined

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A FIVE-STEP GUIDE TO FLIPPING A HOUSE

STEP ONE FIND A PROPERTY

Though all methods of buying a home are possible, many flippers prefer direct sales from the homeowners (or FSBOs). These owners are typically very motivated to sell, there's no realtor to be paid, and there's more time to evaluate the home than there is at an auction. But finding these properties isn't easy. Some flippers send direct mail; some use social media. No matter how you decide to do it, get the word out that you're looking to buy properties if you'd like to avoid realtors and auctions.

to succeed. This is the current flipping market—version 3.0.

If you've looked at a run-down house in your neighborhood and thought, "I could fix that up and sell it for a decent profit," there are a few lessons to learn from those who have succeeded and those who have struggled in the flipping business before you dive in. And they're all informed by the recent ups and downs of the national real-estate market.

ARV is the key

Not every run-down house is a good candidate for a profitable flip. Successful flippers reject dozens of properties for each one they take on. Unlike most home buyers, though, they aren't looking for the right floor plan or the best school district. It's important to understand that a house flipper is a real-estate investor, not a homeowner or a craftsman. That's not to say the quality of the work is irrelevant, but that the decision to flip a particular house is a business decision and the purchase is largely based on one significant number, the after-repair value, or ARV.

ARV is the exit price—what the upgraded house will sell for. Like everything in the flipping process, this number is speculative; an educated guess. A house is worth what someone will pay for it on any given day—no more. So, there is no benefit to being optimistic about the ARV. It's best to plan for the lowest likely ARV, and to see if you will be able turn a profit at that price.

Justin Pierce, a Virginia real-estate investor who has completed about 50 flips, says a great advantage of flipping during market versions 1.0 and 2.0 was that there was a lot of sales activity in very localized communities. Back then, he was able to pull three or four recent sale prices for the same-model house in the same development. That many closely matched comps gave him a pretty good idea of the ARV. Lately, however, he's found that distressed houses in developments are largely gone in his area. They've been snapped up by flippers or DIY owners looking to acquire fast equity. Instead, the potential flips are what he calls "nonconforming." They aren't part of a development and true comparable sales in the same neighborhood or school district don't exist.

This is why watching the Multiple Listing Service (MLS) and really knowing the

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market is important. Justin, who has taken the time to get a real-estate license for MLS access, generates and evaluates his own comps. It's just too risky, in his mind, to rely solely on someone whose interests are not directly aligned with his. He also uses the license to list and show his houses—this way, he gets immediate feedback on the price and can lower it before it sits stagnant on the market. He also uses his license to represent the occasional buyer. Touring houses with a buyer gives him two market insights: He can see the quality of the houses at different price points, and he gets a feel for what is selling.

If you're considering flipping a house, Justin recommends you visit open houses, listen to the comments of visitors, and check out the condition of different houses and see what they sell for. In a similar vein, visit the model homes of big builders to see what is popular—they've already done the market research.

STEP TWO DETERMINE THE AFTER-REPAIR VALUE

Once you have found a property, determine its after-repair value, or ARV. This is how much can you likely sell the house for after you've done the necessary updates and appropriate upgrades. The ARV is speculative, but your success depends on it, so you can't do enough research here. Get to know the neighborhood you're considering working in, find out what buyers in this area and price range will pay for, and study recent comparable sales, or comps. A bank won't write a mortgage on a house unless the appraisal assures them that the house is collateral for the loan. Since the appraisal is based on comps, your ARV should be too.

The hunt is half the battle

While the ARV is the most important number to determine before buying a house to flip, you make your money based on the purchase price. So chiseling away at the front-end cost helps to ensure your profit.

There are four avenues for purchasing a house: through a private sale (for sale by owner, or FSBO), from a wholesaler, through a realtor-listed transaction (often found on the MLS), or at a bank auction. Justin says he's been to one auction and hasn't been back. They don't offer enough time to thoroughly inspect the house to get a handle on the likely renovation costs, he says. And the competitive bidding atmosphere generally pushes the price beyond anything that could reasonably generate a profit. That leaves the other three options.

The MLS is a great tool for price research and it can be a source for finding potential properties. With patience, you'll find flip-worthy deals listed on the MLS, and having an agent to negotiate with on the other side can be beneficial, since they'd like to see the deal succeed.

A wholesaler is someone who looks for properties they can purchase inexpensively enough to resell to a home flipper before they actually come into possession of the property. If the numbers work, wholesalers are a viable way to acquire a property. And anyone can act as a wholesaler. If you get an especially good deal on a property while looking for an investment, sometimes the quickest route to a profit is to sell it to a flipper or someone looking for rental properties without exposing yourself to the risks of flipping it yourself.

But it's often private sales—houses that are sold before listing—that offer the best potential for a return on your investment. Many sellers are willing to take less than market value for an immediate payday over a longer, unsure timeline, even if there's the prospect of a higher sale price. A common example is someone who has come into possession of a house after a parent's death. In many cases, the home needs a great deal of work, so they are willing to take an immediate cash payment to be rid of the property. By selling the house to a real-estate investor, they eliminate the mortgage contingency, sell it as-is without cleaning or fixing the property, and close the sale in as little as a week. In exchange, they take a hit on the sale price.

How do you find these sellers? It isn't something that happens overnight. Liz and Jason Haynsworth started flipping houses in 2009 in East Dallas as a sideline and it quickly became their full-time job. For the Haynsworths, as with most house flippers, a big part of the work is finding prospects. They have found mailings to be a cost-effective method. Rather than just blanketing a zip code with postcards, they target things like appraised value, absentee owners, eviction proceedings, preforeclosure action, and expired MLS listings. The point is to

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let people who might be thinking of selling know that you're buying.

Another of their strategies is to post and advertise on Facebook, Instagram, and Twitter. The idea is that when somebody says, "I need to sell this house," they, or someone in their circle of friends, thinks, "Oh, Liz and Jason buy properties."

Once you have a lead, the next step is a careful screening. For Justin, screening is a matter of listening to the language people use. If the phrase "market value" comes up, it's probably best to move on to the next opportunity. To smooth the negotiation-and-sale process, Justin says he is up-front about his costs and what he can pay for a property, explaining why he has to buy at a discount and how he's not pocketing that much of a profit when he resells the property.

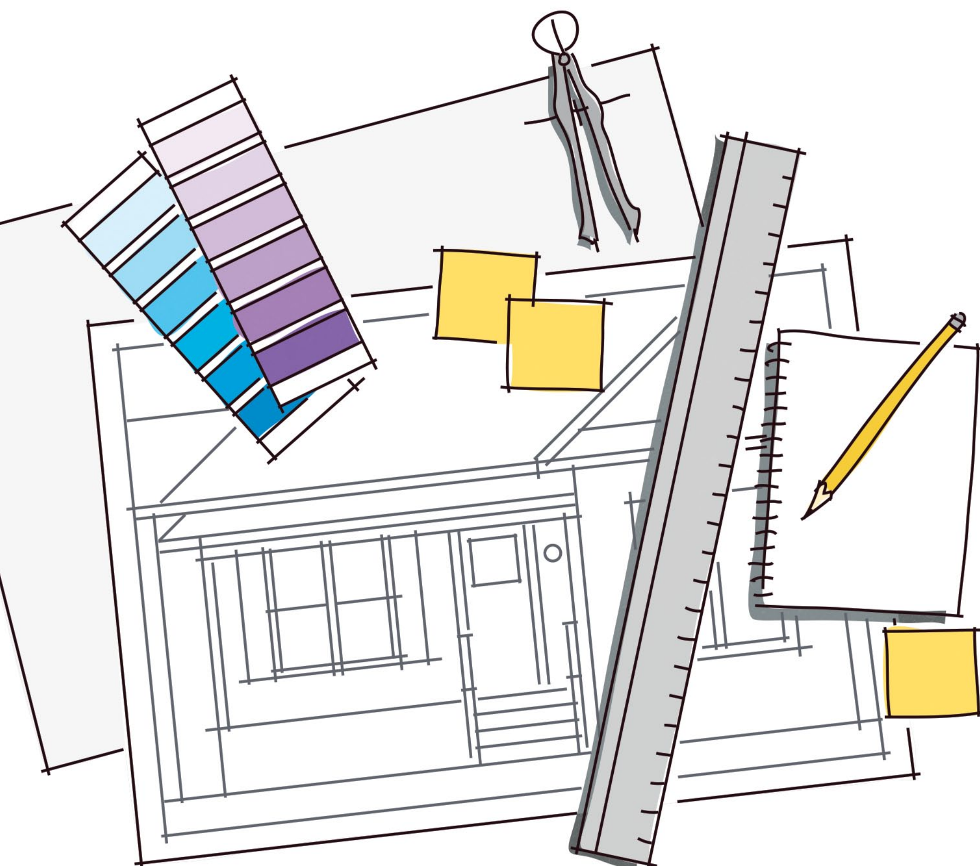
Business costs are time-sensitive

There are two types of costs involved with flipping a house: business costs and renovation costs. The business costs are pretty straightforward—they include transaction costs and carrying costs. The transaction costs are real-estate-agent fees, transfer taxes, closing costs, capital-gains taxes, and income tax. The carrying costs include interest, property taxes, utilities, and maintenance like lawn mowing and snow plowing, which are time-sensitive. If you blow your renovation timetable, you blow your financial-cost calculations as well. So, successful flipping is based on minimizing the time you own the house. Not only does a quick turnaround lower your carrying costs, it means that you're more likely to sell the house in the same market conditions as you purchased it, improving the odds that your ARV is accurate.

For Justin, an ideal flip is four to five months from closing to closing—when you factor in one month for listing on the market and one for a traditional closing on the resale end, the remodeling work needs to happen quickly. Depending on your relationship with the contractors you'll be using on a project, you might want to consider building deadline rewards and penalties into the contract to protect yourself against the cost of owning the property for extra weeks or months.

Investors find financing for their flips from a handful of sources: Some pay cash; some borrow from family, friends, or fellow investors; some go through hard-money lenders. Banks often offer the lowest interest rate, but the process is slow. If a sale depends on a quick closing, bank financing isn't an option. The Haynsworths use friendly investors—financial partners with whom they have a relationship. This gives them a better rate than hard-money lenders offer, and the ongoing relationship is advantageous as well. After the first few flips, they approached a local bank for a line of credit. They felt the local bank would be more flexible than a national bank, and they developed a business plan to accompany the successful pitch.

Justin is more likely to use a hard-money lender. These lenders are more expensive than a bank, with interest rates in the 12%



STEP THREE DO THE MATH

Once you've determined the property's potential ARV, it's time to crunch some numbers to figure out how much you can pay for the house and still turn a profit. Folks flipping houses all across the country use the same basic equation to determine their maximum purchase price. The equation gives you a starting point; each deal requires fine-tuning based on specific projected costs and situations. To do the math, you'll need to have a renovation-and-repair budget and timeline. The timeline will help you determine the likely financial costs and carrying costs. And you need to have a target-profit margin. Most flippers aim for a profit of 15% of the ARV. The formula is simple: ARV minus costs, profit, and renovation budget equals purchase price. Here's an example:

$500,000 After-repair value
- $75,000 Financial and carrying costs
- $75,000 Profit target 15%
- $50,000 Renovation budget
= $300,000 Purchase price

If you can't acquire the house for this purchase price, it's best to walk away and look for another property. There's too much speculation in the math and uncertainty in the process to add more risk to the equation.

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to 15% range, plus perhaps four points. The advantage is that they finance real-estate investments every day and the cash is immediately available, which lets him work with 50% to 75% debt, so he can do more projects to both generate more money and spread out the risk.

One thing that Justin believes remodelers and builders overlook when they take on a flip is determining if it is actually their best opportunity for profit. If the return on building a spec house is greater than your expected return from flipping the house, that's where your money should be going. (If flipping three houses a year gets you a larger return than building one spec house a year, you should be flipping houses.) It is important to not only evaluate your return on the money that you invest in the project for the time it's invested, but also to make sure you are paid for the time you sink into the project, whether it's labor or paperwork.

Stick to the plan

It's also important to estimate your remodeling costs before you purchase a property because the offer price for the house is driven by this cost. If you'll be doing the work yourself, make sure to do a thorough inspection of the house to evaluate its condition; if you're contracting out the work, bring in the contractor and subs to get estimates and a reliable schedule. Unaccounted-for expenses will come out of your pocket at the end of the deal.

Though every project will need a different number of repairs and renovations, there are some things you can do to protect yourself. Working in familiar neighborhoods gives you a sense of the problems you are likely to find. Liz and Jason developed their model working in a neighborhood dominated by

STEP FOUR PURCHASE PROPERTY AND GET TO WORK

Two sure ways to diminish your profits are to blow the renovation-and-repair budget and/or the timeline. Your renovation-and-repair plan should be based on what buyers are willing to pay for in your specific market. In many markets, "upgrades" will never yield a return from cost-conscious buyers. They will only lower your profit. Also, every day added to the renovation-and-repair timeline adds to your carrying costs. During this phase of the flipping process, your job is to stay focused on executing the plan to stay on deadline.

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ranch houses. They gut every house and remodel each with a midcentury-modern flair, and can safely budget $100,000 for remodeling house after house in this area.

Developing the budget is one thing; sticking to it is another. Rick Trimble started flipping houses in 2006 in Washington, D.C., right at the tail end of the housing boom. About 20% of the local market was house flips at that point. He hoped there was a market in slightly higher-quality finishes and finish work. In the projects he did from 2006 to 2008, he found there were opportunities to add a built-in or a drop zone by the door that would add a couple of hundred dollars here and there. These decisions ate away at the repair budget and the schedule, and in the market of falling home prices, he wasn't rewarded for these spur-of-the-moment extras. Listening to potential buyers touring his projects, Rick noticed that their focus was on price, not details and materials.

It's critical that buyers pay for anything that you put into the house. A $10,000 appliance package in a $200,000 house doesn't make sense; it won't move the selling price any more than a $2,000 appliance package would. Rick's mistake was to treat his first projects as calling cards for his fledgling remodeling business. Instead of booking profits, he just recouped his costs. The lesson here is that if you decide you want to flip houses, you need to make sure there is a return for every outlay and hour of labor in the project.

The other lesson to learn from Rick's experience is that house flipping involves risk. The model requires very short-term ownership of an asset, speculating that improvements will raise the price enough to recoup the investment and earn a return. In hindsight, Rick purchased his properties at the height of the market and had to sell as prices dropped. Of course, it's hard to identify that inflection point in real time; this concerns Justin and Liz in the current market.

STEP FIVE SELL FOR A PROFIT

Don't waste any time getting your property back on the market once you're done with the renovations and repairs. Not only will you continue to incur carrying costs as you wait to sell, but the likelihood of the market changing increases. If you did your research, your property will now be precisely marketable to buyers looking for homes in your neighborhood and in the price range of your speculative ARV.

Still interested?

The number of flipped properties in 2016 and 2017 were the highest since the 2006 peak. And while the gross profit of flip sales has climbed, net profits have fallen consistently according to ATTOM Data Solutions, an industry data group. This is a sign that there are a large number of people entering the flip market and raising the purchase price of homes. And while sales prices are rising, the rate is relatively modest and not enough to offset the gains on the purchase side.

The Haynsworths are now focused on new construction—in the sizzling Dallas real-estate market, the pressure on the purchase price of potential flip properties from large, highly capitalized investment groups has squeezed the profit margin. The profit potential for flipped houses now seems to be in smaller real-estate markets that aren't saturated with investors focused on flipping. If you're in one of these markets and still attracted to flipping houses, do a gut-check: What's your tolerance for risk? Are you patient enough to wait for the right deal? Can you deal with uncertainty? Remember that you're not the only one competing for labor in a tight market, and that rising interest rates not only affect you but also the purchasing power of potential buyers. □

Sean Groom is a contributing editor.

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