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DON'T EXPECT SUCCESS. PREPARE FOR IT!

In my last letter, I referenced the fairy tale, the Three Little Pigs and equated a downturn to the big bad wolf at your door. During the last two recessions, I have been the little pig in the brick house while many of my cohorts have seen their properties fall into disrepair and often times get taken back by the bank. The financial effects along with the emotional suffering can be devastating.

The purpose of my splash of cold water is not to dissuade you from future investments or scare you into selling, but to share a reminder that we are in a cyclical and not a secular business. Much of the preparation is mental, so that you don't get "auction fever" and lose focus on the big picture.

During the go-go days of 2005-2007, many in real estate used phrases like "new paradigm" and "supply and demand problem" which gave justification for buying properties whose cap rates were lower than the borrowing rate known as "negative leverage," and causing unresolved issues for at least a decade. These signs caused me to halt my buying and even do some profit taking by selling a few of my buildings.

Thus far in the current cycle, I'm only seeing negative leverage in A properties in A areas, but I am still buying in other areas when I see a deal that fits my criteria.

I want to share some strategies to build the brick house during the boom times so that you prepare for and can maintain your success through the bust cycles. The goal is to be able to manage well during the boom times, so when the bust cycles come, you will still have the ability to make purchases. (During the "bust" is almost always the best time to buy.)

Strategies:

- Get ahead of your capital improvement projects while you are the most profitable. When vacancies rise and rents decrease, you won't feel as generous, so this is the time to make your property shine. Being the nicest on the block makes renting much easier.
  - Budget out major items for the next 20 years (i.e. roof, exterior paint, pool re-plaster, plumbing) so you aren't surprised.
- If it is time to refinance, consider a 10 year fixed rate loan. Also don't pull out so much money to stretch your investment. If you take the loan to a LTV (loan to value) of 80% and values dip 25%, you will be underwater. That would make refinancing very difficult should your loan came due. I am in the process of refinancing and will stay at or below 55% of current LTV which I believe to be very conservative.
- Properly train your team in customer service and marketing. It is easy to get fat and lazy during the boom times but as Warren Buffett said, "only when the tide goes out do you discover who's been swimming naked."
- On purchases, consider coming in with a bigger down payment to keep the loan level manageable.
- When underwriting these purchases, run a stress test scenario where you have a drop in occupancy to 90%, a 5% decline in rents and 5% higher utility expenses. Can your property survive?

The longer the boom cycle goes, the more probable the end is near. Be ready and plan for your success! You'll be happy you did.

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