

RICH  DAD.
ADVISORS



FOREWORD
BY
ROBERT
KIYOSAKI

The ABCs of Property Management

*What You Need to Know
to Maximize Your Money Now*

KEN MCELROY

The ABCs of Property Management

*What You Need to Know
to Maximize Your Money Now*

KEN MCELROY

The ABCs of Property Management

*What You Need to Know
to Maximize Your Money Now*

KEN MCELROY



If you purchase this book without a cover you should be aware that this book may have been stolen property and reported as “unsold and destroyed” to the publisher. In such case neither the author nor the publisher has received any payment for this “stripped book.”

This publication is designed to provide competent and reliable information regarding the subject matter covered. However, it is sold with the understanding that the author and publisher are not engaged in rendering legal, financial, or other professional advice. Laws and practices often vary from state to state and country to country and if legal or other expert assistance is required, the services of a professional should be sought. The author and publisher specifically disclaim any liability that is incurred from the use or application of the contents of this book.

Copyright © 2008, 2014 by Ken McElroy. All rights reserved. Except as permitted under the U.S. Copyright Act of 1976, no part of this publication may be reproduced, distributed, or transmitted in any form or by any means or stored in a database or retrieval system, without the prior written permission of the publisher.

Published by RDA Press

Rich Dad Advisors, B-I Triangle, CASHFLOW Quadrant and other Rich Dad marks are registered trademarks of CASHFLOW Technologies, Inc.

RDA Press LLC
15170 N. Hayden Road
Scottsdale, AZ 85260

480-998-5400

Visit our Web sites: RDAPress.com and RichDadAdvisors.com

First Edition: May 2008

First RDA Press Edition: October 2014

Cover Design by Chris Collins | American Design Co.

ISBN: 978-1-937832-54-4

102014

This Book is Dedicated to The Mckenzie Monks Foundation

Helping Kids Cope With Cancer

www.MckenzieMonksFoundation.org

Contents *Foreword* by Robert Kiyosaki *Introduction*

Section 1: Should I Manage My Own Property or Hire Someone to Do It for Me?

Chapter 1 Size Doesn't Matter

Chapter 2 Property Management Systems

Chapter 3 Cash Flow Management

Chapter 4 A Month in the Life of an Owner-Manager

Section 2: How Do I Find a Good Property Manager?

Chapter 5 Not All Property Management Companies Are Created Equal

Chapter 6 Employees, Systems, and Structures: The Backbone of a Company

Section 3: How Do I Hire a Good Property Manager?

Chapter 7 Hiring a Good Property Manager or Management Company

Conclusion

Resources

About the Author

Foreword

by Robert Kiyosaki

This book has been a long time coming. When I wrote *Rich Dad Poor Dad* in 2000, I said that a great property manager was the key to success in real estate investing. The reason for this is that great property managers create value. That's because value, when it comes to investment real estate, is not only a function of markets, but it also impacts your bottom line. Your real estate is only as valuable as your renters think it is—what they are willing to pay in rent. Rental income is ultimately the aspect of real estate you have the most control over. (And thus it's the aspect that presents the greatest opportunity for failure as well.)

Property managers are valuable members of your team because they specialize in your real estate market, and they know how to maximize your investment's income-producing potential.

Thankfully, I'm smart enough to follow my own advice. That is why I sought out Ken McElroy to be an advisor to me on real estate investing and property management. Ken is an expert on both. His company owns and manages thousands of apartments across the United States. His knowledge and experience adds incredible value to my team.

That is also why Ken was the only option when we decided to offer a book on property management. You may already be familiar with Ken and his work. Perhaps you've seen him speak at a Rich Dad seminar, or maybe you've read his best-selling books, *The ABCs of Real Estate Investing* and *The Advanced Guide to Real Estate Investing*. And while Ken is an undeniable expert on the business of real estate investing, I'm sure he will tell you that his first love and ultimate expertise is property management—that is, *creating* value. In the end, it's what sets Ken far ahead of the pack. And as he will tell you, it's the key to what made him the successful investor and businessman that he is today.

While Ken's previous books were tremendous guides for how to invest in real estate, this book may be the most important book Ken has written for the

Rich Dad Company. Finding quality real estate deals to invest in is easy. *Sustaining* those investments and *creating* value for those investments is anything but. It takes a keen eye and management knowhow, something many investors lack.

Property management is a long-term proposition. Finding, buying, and selling real estate is a relatively short process. In my experience, most real estate investors are taken off guard by the blood, sweat, and tears that go into effectively managing a property. And as Ken will show you, your preconceived notions of what it takes to be a great property manager are most likely the stuff of fantasy.

But in order to become a truly great real estate investor, you need a thorough understanding of the principles of sound property management, the exceptionally large amounts of time and energy it takes to manage a property effectively, and the ways in which great property management can bring value to your investments.

So if you're ready to take your real estate investing to the next level, this book is for you. It will be an invaluable resource. You will learn all these things and more. Most important, you will learn them from someone I consider to be not only a good friend and valuable business advisor, but also *the* expert on the business of property management and value creation.

Robert Kiyosaki

Introduction

A Jumbo Problem

Jumbo had parked his wheelchair behind some landscaping in the courtyard to provide cover. The sweltering Phoenix heat was in full force, and beads of sweat rolled down his face as he sat and listened in silent tension. Slowly his hand moved down to the compartment on his wheelchair where he kept his semiautomatic. With practiced precision, he flipped the safety off and waited. The Phoenix police had set up a perimeter around the building.

“Don’t make this any harder on yourself, Jumbo!” the police negotiator called out over the bullhorn, his voice breaking eerily through the silence and echoing off the building walls. “You’re not getting out of this. We’ve got the whole building covered. Just come on out and let us take you in. Nice and easy.”

Silence fell over the courtyard again, pierced only by the occasional buzzing of a fly or the passing of a random car. Jumbo knew he was in serious trouble. Finally, Jumbo spoke.

“Screw—you!” he yelled out.

And with that Jumbo’s hands reached for his wheels, and he raced off through the apartment building and down the courtyard path. It didn’t take long for the police to catch up to him. In one swift move the police had knocked over his wheelchair and had Jumbo in cuffs. Just as quickly as it had begun, the standoff was over. When the police found the semiautomatic and the drugs, it was obvious how much worse the situation could have been.

This story may seem like something out of a crime fiction novel, but stories like this happen every day and are often great dinner conversation for the property management industry. The owner of this property was a personal friend who had turned to my company for help, as he was facing foreclosure.

The building had sub-par residents, many with criminal backgrounds, who were allowed to move in. These residents were basically running the place by selling drugs and running prostitution rings. The property was unsafe, which was

driving all the good residents out. And because most of the residents weren't quality residents, most of the rents weren't paid on time. In fact, the revenues for the property slipped so low because of vacancy and nonpayment that most of the normal bills, including the mortgage, couldn't be paid. The owner was in dire straits.

Jumbo was just one of those seedy residents allowed to move into the building. He was a known drug dealer with a criminal background who was wheelchair-bound because of crippling gunshot wounds from a previous drug deal gone bad.

This was just one of many examples and an all-too-real reminder that the lack of good property management can put any investment in jeopardy.

In the end, Jumbo was just the tip of the iceberg when it came to this building. It was full of criminal activity and unruly sorts. In fact, one of the main reasons Jumbo was caught by the police was that there were so many police calls to the property address that the property was a huge liability to the surrounding neighborhood. Therefore, with our cooperation, the local police set up a police substation at the property management office and started a surveillance operation from some of the vacant apartments.

I tell you this story not simply because of its shock value, but to dispel the myth that property management is a dull, no-brainer job. It's anything but! As you read this book, you will hear many stories that you may not have expected—or, if you have been managing property for a while, they may seem all too familiar. The number one job of a property manager is dealing with residents, and the number one rule of dealing with residents is that there are no rules. Any time you take hundreds of people with diverse backgrounds, personalities, and motivations, you have a recipe for the unexpected. The amazing thing about Jumbo's story is that it isn't even shocking to me anymore.

Any way you slice it, property management is a down-and-dirty job. But if it's done correctly it can add incredible value to your investment. I know this because I've been doing it for over 25 years, and have seen firsthand the power of property management done right.

And after over 25 years in the property management business, there is one thing I can assure you:

Rich Dad Tip

Poor Management = Poor Profit

By the way, and this should not be too much of a surprise to you; poor management in almost every business usually equals poor profit, not just in property management. I am sure you can relate.

One of the main reasons businesses fail is due to poor management, period. Have you ever been somewhere and had terrible service? Perhaps a restaurant, a hotel, an automotive shop, or a retail cashier? In most cases, you would never go back to that place of business. Well, don't think you are unique in that experience. The beauty of all this is that for every failing business there is someone in denial or an ego that is directly responsible. The facts are usually the same: high turnover, poor training, and poor service.

I think of these people and businesses as donors to your financial future, and that's how I look at poorly managed properties.

Here's the Story

This book is not just about how to manage property or find a good property manager. Though it covers those things, it's also about stories. Every property has a story or stories that tell you as much about what management will be like as the financial statement will.

Many people are surprised when I tell them that a financial statement can tell a story, but it's true. Numbers are the universal language, and once you learn how to read them fluently you will be able to see patterns that will give you a very clear picture of the way a property is being managed. I can look at any financial statement for any building and in a matter of minutes be able to determine what is being done right and what is being done wrong in managing that building. I can tell whether rents should be raised, or even more specifically if the property is suffering from poor customer service. This book will teach you to listen to professionals in the property management business no different than you would any other service, and to learn from the stories others and ultimately your financials will tell you about your investment.

The beauty of managing property is that you don't have to settle for the story

as it is. Rather, you can create the story as you see fit through sound principles. Do you have a property that is filled with problems and ruffraff? You can rewrite that story; otherwise it will continue to write itself in the same way. Ultimately, the choices you make in managing your property will determine your profit.

Much as I am writing this book, choosing what direction it will go, what words to use, and what I wish to tell you, you have the power of changing the story of your properties and creating a chariot out of a pumpkin if you listen and learn from other property managers, learn how to read your financials thoroughly, and apply the principles you have learned. So, let me tell you my story.

I'll just get this out on the table: I wasn't planning on doing property management for a living. I jumped at the free rent. I thought the job would be easy and something to do while I was studying for my real estate license. In other words, I stumbled into it. A lot of people do.

My first job out of college was managing a sixty-unit building where I both lived and worked. It was my first job out of college. It turned out to be a bigger job than I ever could have imagined. I was the only staff on-site and responsible for the collection of rent, leasing of units, all the maintenance, resident communications, and enforcement of rules and regulations. For this I received a salary of \$600 per month and a free one-bedroom apartment. Rents at that time were running around \$300 per month for a one-bedroom, so all said and done, I was making less than \$1,000 per month.

Coming out of college with a mountain of debt due to college loans and never really making any money, I thought it was a great deal. You may not be coming right out of college, but chances are when it comes to property management, you're as naive as I was. "How hard can collecting a few rents be?" I thought to myself. My education was just about to begin.

As is the case with most young adults coming out of the American education system, with a degree I could hang on my wall, I had no real practical knowledge and absolutely no financial education. So, while the money I was making wasn't anything to write home about, the education I received from that sixty-unit building was immeasurable. I like to think of it as a paid internship. It takes the edge off a little bit.

My first task was to fire the existing managers. Here I was, a powder-fresh twenty-two-year-old kid giving the pink slip to someone. The two managers had allowed all their friends to move into the building and host parties involving alcohol and drugs. As a consequence, rents were slipping, and policies were not

enforced—always a recipe for disastrously devaluing a property. Beyond that, some of their friends were actually drug dealers and were operating from the building.

I thought firing someone was hard, but it paled in comparison to the work that came afterward. The problem with coming into a building like that is even though you fire the managers, the residents are still there. I quickly found out that to be a property manager was to face resistance in everything you do. People complained, moaning and groaning about everything. In some cases, residents even threatened me with bodily harm. (Thankfully, no one ever acted on those threats.)

As you can probably tell I was not very popular. It was a very uncomfortable position for me to be in because I lived in the building and these were my neighbors. At one point, I came out to find my car tipped over in the street.

All sorts of wild things happened at the Seattle building. For instance, a skinhead stole my wallet. When I confronted him, he denied it. “Go ahead and check,” he said. I found it in a box on his living room floor.

I had a really nice guy from the building knock on my door with his face all bloodied and in hysterics because his lover had beaten him up, and when I went up to confront the resident I was thrust into a three-way lovers’ quarrel.

Believe me, there are many more stories just like these. The point is that lots of crazy stuff happens in property management, stuff you’ll never learn how to deal with in a classroom.

Lucky for me, the company I worked for was a solid management company and provided all the support I needed. Most importantly, they had excellent training, systems, policies and procedures, and a central accounting department that allowed me to do my job efficiently and effectively. I eventually gained more responsibility, obtained my real estate license, and ended up having a portfolio of eight buildings in the Seattle metropolitan area—a 100-mile district. These consisted of a variety of building types from a single-family house to a four-plex, an eight-plex, and a twenty-four-unit building, among others, for a total of fewer than fifty units.

The clients I managed for in this portfolio were probably much like you. They were part-time real estate investors who still had full-time jobs and had chosen to hire a third-party management company to oversee their real estate investments. For this they paid a small percentage of the rent collected. Generally this consisted of around 6 percent to 10 percent, depending upon the size. At this time rents averaged around \$400 per month, so on the fifty units we

collected about \$1,600 per month in property management fees to cover my salary, corporate overhead, and my expenses.

Here's the rub. This was back in the mid-and late 1980s, and in order to be efficient, I bought a car phone. Aside from impressing the ladies, this phone was essential since I was driving hundreds of miles a week in my Volkswagen Scirocco all over the Seattle area to look after the properties. The problem was that the car phone cost about \$500 a month. That coupled with the gasoline I used equaled about \$ 1,000. I was working about sixty hours a week collecting rents, coordinating maintenance, overseeing legal actions, and showing units. The management company was losing money because my expenses and their expenses far exceeded the property management fees. It became easy to see that in order for me to continue with the company, I had to increase my portfolio and my client base—and fast. This was one of my very first lessons about business: If I cannot pay for myself, I am expendable.

Beyond that, I still had to deal with the same old crap—literally. One of the biggest challenges in property management is parking (an old adage goes, “Property management is simply people, pets, and parking”). In downtown Seattle, I had an ongoing feud with a resident at one particular building regarding the parking situation. One day I came out to find that the driver's window to my Scirocco was broken. I did a quick search, but couldn't find anything stolen. I got in the car and set out to do my rounds. I quickly found out the resident had shoveled dog poop onto my engine—something I discovered about thirty miles down the road after it had burned into my engine block and started coming through my vents. For weeks on end, I had a very real reminder of how disgruntled the resident was about the parking situation, and the fact that I had a car phone didn't impress the ladies that much anymore.

During my time in Seattle, I was able to expand my client base to a portfolio that equaled 450 units spread out through twenty buildings in the greater Seattle metropolitan area. Eventually, I had the opportunity to move to Las Vegas to start a satellite office for the company. I was twenty-six years old and had four years of property management experience, over 10,000 hours.

In Las Vegas, I initially helped secure a new property management contract for a 900-unit building. This gave the company a very strong business base in the city to grow from, but this was a remote location for the Seattle-based company. I relied heavily on the corporate accounting system, but I was responsible for business growth in Las Vegas, as well as day-to-day operations.

This was the first step in my journey toward starting my own company.

When all was said and done, after eight years in the business I had grown the portfolio in Las Vegas to 4,000 units. The properties I secured were larger and larger, and the profits began to grow for the company that employed me, but not for me. I became wiser to the game of business, and I moved to Arizona to form my first company. I was twenty-nine years old.

I started my first company with two partners; one was a friend and business associate whom I had met while working at my previous employer. Together we grew our company's portfolio to 4,000 units, about \$1 million in annual revenues, and life seemed to be really hitting on all cylinders.

But I was naive in business, and hadn't consulted a team before forming my partnership. Consequently, I made a lot of handshake agreements and trusted a lot of verbal commitments. The company grew rapidly, but my business partners were much more seasoned than I was. I learned some big lessons from my first business venture, and I made the decision to move on. I learned that life's lessons come at you fast, and what you do with those lessons will determine your financial future.

I now had a taste of owning a business, albeit a failed partnership, but I had no real assets and little savings. I faced the decision of once again working for a large national company with a nice six-figure salary, or making a go of it with my own business.

After a couple months on the beach, I decided that I would give the business world another try, and I started McElroy Management. My lush offices consisted of a computer in my spare bedroom and one management account, which I visited every day, a 100-mile round-trip. It was my real first step in the CASHFLOW Quadrant (see chart) from an E to an S because I no longer had support from a national company, nor could I share the workload with partners because I didn't have any.

The CASHFLOW Quadrant is a concept that Robert Kiyosaki and the Rich Dad team speak of frequently, and Robert wrote about it in the book *Rich Dad's CASHFLOW Quadrant*. It is a key concept in the Rich Dad philosophy. Put simply it states that there are four types of people in the business world: Employees, Self-Employed, Business Owners, and Investors.



Rich Dad Tip

Most people choose security over freedom.

Very seldom is someone able to just move from an employee to a financially free investor. As Robert and the Rich Dad team teach, the process of moving through the CASHFLOW Quadrant is a journey. This was the case for me. My journey took over 15 years.

Employee E	My first eight years out of college.
Self-Employed S	I worked seven days a week to meet the demands of my clients and to grow my businesses. I had no employees at the beginning, and slowly built my business to the point where I could actually take a day off. Had I decided to just stop working, I would have been in the poorhouse because the money would have stopped coming in.

<p>Business Owner B</p>	<p>After a few years, I had built my company into a successful business. I had thirty-plus employees working under me, and if I wanted to take some time off money still came in. Finally, after years of hard work my money was starting to work for me instead of me working for my money.</p>
<p>Investor I</p>	<p>As a successful business owner, I was free, but not independent. Meeting my business partner, Ross McCallister, changed my life. Together we began not only managing for clients, but investing in large apartment buildings ourselves. Not only were we the managers, but now we were the owners too. MC Companies now has many corporate entities, all of which make money even when we are gone for months at a time.</p>

By starting my own business, I moved from an Employee to a Self-Employed individual. This was the first step toward my financial freedom. Eventually, I developed McElroy Management into a large business, overseeing 6,000 units. This made me a business owner and moved me over to the right side of the CASHFLOW Quadrant—the side where wealth really starts to be generated. If you are an E or an S and stop working, your cash flow will stop (in the form of a paycheck). If, however, you are a B or an I, you will have the freedom to create wealth even when you aren't working.

As Robert says, “Business and investing are team sports.” I took those words to heart when I met my business partner, Ross McCallister, in 1996, and merged McElroy Management with his company McCallister Management to form MC Companies. This was the final step in my CASHFLOW Quadrant journey, as I began not only to manage other people’s investments, but to invest in much larger properties.

Today, my partner, Ross, and I own more than 8,000 units—over \$400 million in property—and manage in excess of 5,000. Under the companies we have eight different corporations that range from ground-up construction to corporate housing. All of these companies work for us to generate wealth, and not the other way around. But the CASHFLOW Quadrant is a journey, not an overnight transformation. You have to take little steps toward your goal of financial freedom. Eventually, they will add up in a big way. In fact, my very

first investment property was a two-bedroom, two-bathroom condominium in Scottsdale, Arizona, that I bought after I started McElroy Management.

After my first book, *The ABCs of Real Estate Investing*, was published, I had the opportunity to speak with a lot of people as I traveled with Robert Kiyosaki and the Rich Dad team around the world. Many had used the principles in that book to secure their first properties, and thus began the road to true financial independence. Most didn't have a clue, however, as to how to go about managing their investments. I began to see that there was a huge need for a book on property management.

This book is inspired by three questions that I continually receive when I speak around the world at Rich Dad seminars:

- Should I manage my own property or hire someone to do it for me?
- How do I find a good property manager?
- How do I hire a good property manager?

As I mentioned before, this book is not only about the mechanical process involved in the answers to these questions, but also about the stories of those who can give insight into those answers. What I mean is this, it's not just about the what, but also the why. So sit back and relax, because it's going to be a wild ride as we review some notes from the property management underground.

Section 1

**Should I Manage My Own Property or Hire
Someone to Do It for Me?**

Chapter One

Size Doesn't Matter

The title of this chapter is a little tongue-in-cheek, but when it comes to applying the principles of good property management, size really doesn't matter. Period. When you don't apply sound property management principles, however, and things start to go horribly wrong, then this principle applies: The larger the property, the greater the financial loss.

Rich Dad Tip

Sound Principles of Property Management Translate to Success No Matter What the Size of an Investment I can think of two properties that illustrate this point perfectly. One was a large multifamily property in Arizona my company managed, the other, a single-family home in Washington that was owned by my inlaws. (All names and identifying details have been changed.) Not only are these stories tragic in their own way, but they're also common. Investors continually make the same mistakes when it comes to managing real estate, and the effects are devastating no matter what size the property is.

It's Nice but...

My company managed a building in Arizona that perfectly illustrates common mistakes and the results of not applying sound property management principles. To this day the property is infamous in my company even though we haven't managed it for years.

The building consisted of 200 units in a very nice suburban area of town, and was purchased by a group outside the state. Of the many mistakes made by the group, they had purchased the property sight unseen nor did they have anyone to inspect the property. Additionally, they knew nothing about the market. Instead of hiring a local management company with knowledge of the market, and connections with local vendors, they chose to manage in-house to "save" on management fees, and hired an inexperienced person, a "friend" they knew, to fly to Arizona and look after the property once a month. The result was a disaster. This basic mistake cost their investors *millions* of dollars.

After realizing that they were in a very serious financial predicament, the managing owners contacted me and asked my company to manage the property for them. Reluctantly, I told them I would. I knew that this would not be easy by any means, and my initial fears were validated after we took over the property and thoroughly investigated all aspects of its operations. The following is a letter I wrote to the owners, explaining the steps we took to begin getting the property in order. The amazing thing is we spent every single day of an entire month using full-time labor to produce the information in this letter. If you find yourself shaking your head in disbelief as you read, believe me, you are not alone.

In accordance with our conversation today, following is a summary of issues encountered in our first three weeks at the property.

1. Property Status—

Upon our arrival at the property, occupancy was 160 units, 80%, with 14 units pre-leased plus four un-leased on notice to vacate. Of the vacant pre-leased units, five were cancelled/denied. In looking at the Rent Roll history, we have determined that the number of move-ins per month averaged 12 all of last year.

February rentals thus far total 13, of which 1 has been denied due to poor credit. We anticipate several more rentals this month. We have targeted units based on a combination of length of time vacant, location and style. Premiums have been implemented on downstairs units (\$25, based on larger patio). Large three bedroom units have also been increased by \$45

to \$1,050/mo.

Current Update—(160 units occupied upon take over)

Units Currently Occupied:	170	85%
Vacant Leased:	176	88%
Net Leased:	172	86%—(after notices to vacate)

2. Maintenance Issues—

A. Market Ready Units—Of the 40 units vacant when we began, none were ready to rent. We walked all units and assessed damages. Per the breakdown sent to you February 20th we have found that 70% of the vacant units have moderate to extensive damages. Some of these require major renovation and have been “down” over 200 days. Currently, there are five units market ready, and we have moved in nine units.

B. Maintenance Service Requests—Outstanding maintenance service requests upon take over totaled 59. Over the course of the past three weeks, we have utilized maintenance staff from other McElroy properties to help us turn units and get caught up on all service requests except for those that are roofing related. Because of the roof issues, there are some very upset residents who are ready to move out.

C. Staff—The existing maintenance staff has been assessed, and we have determined that both the supervisor and technician will need to be replaced. Schedules for make readies, service requests and grounds work were not being met. We have hired replacements for both positions.

D. Roofing—Roof leaks have been detected throughout the property, specifically in five occupied, and twelve vacant units. Additionally, virtually every building has some degree of breezeway and/or patio lid damage. The result of these leaks has created major interior damage to the drywall, carpet, appliances, and paint. Additionally, we have detected mold in a number of units that will need professional remediation. It is our understanding that there is no warranty from the recent roofs replaced in the last two years. As a result, we have contacted one of our preferred vendors, who has assessed all damage. What they found was that the method used in repairing the roofs previously was a layer over the existing built up roof. They further indicated that the storage units, where we are having severe leaking, were not treated beyond application

of tar paper and roofing cement. The bid is based on long and short term repairs. In the meantime, minor remedial repairs will be made immediately. **Estimated Cost: \$30,000**

E. Patios—Seven occupied, and two vacant upstairs patio decks have rotted, and are a major liability. This is a result of standing water on artificial turf. We have determined that the best and least costly repair will be to remove the turf, and overlay the existing plywood (if viable) with another sheet of plywood using drywall screws. An elastomeric product will then be applied to prevent future damage. This is something that we will be addressing immediately, since it is a safety issue. Residents cannot use their decks because they could fall through the dry rot and seriously injure themselves. **Estimated Cost: Nine decks @ \$250 each = \$2,250**

F. Hot Water Heaters—Five hot water heaters have required replacement this month as a result of rusting out. This work has been done in-house. **Estimated Cost: \$2,000**

G. Carpets/Flooring—Upon walking all vacant units, there are 10 that will need carpet replacements, with a potential of an additional two that may not come clean. It appears, however, that the vinyl in all of the vacant units is in good condition. **Estimated Cost: \$9,000**

H. Interior Doors—31 doors are damaged/missing due to resident neglect in vacant units. **Estimated Cost: \$1,000**

I. Appliances—Seven refrigerators and one range are missing or damaged and need replacement in vacant units. **Estimated Cost: \$3,500**

J. Windows—Due to vandalism, six windows are broken in vacant units. Downstairs windows are boarded up. **Estimated Cost: \$750**

K. HVAC—Two condenser fan motors need to be replaced (robbed for use in other units). **Estimated Cost: \$550**

L. Drywall Repairs—Many of the vacant units have significant drywall damage due to roof leaks and resident abuse. The prior assistant manager's unit has major drywall damage due to vandalism. The recently evicted assistant manager moved into the adjacent unit and kicked a hole through the drywall to gain access to her previous unit. Mold is also a concern, and units may need remediation. **Estimated Cost: \$ 15,000**

M. Cabinets and Drawers—A combination of 15 drawers and cabinet

doors are missing/damaged in vacant units. **Estimated Cost: \$500**

N. Tennis Court—It has become necessary to lock up the tennis court due to the broken fence. Several support poles are rusted through and present a liability. We are accepting bids for repairs. **Estimated Cost—\$2,000**

3. Cash Position—Collections thus far this month total \$92,000.

This amount does not include the \$12,000 in pre-paid rent that was deposited into your account. Expenses so far, including open accounts payable and the invoices you turned over to us yesterday, total \$110,800. We estimated a negative cash flow for the next six months of approximately \$100,000 (after payment of the monthly accounts payable).

4. Other Issues—

A. Delinquent rental payments are high, due to very poor resident profile. We will most likely evict 30-40 residents.

B. Due to the recent murder and vandalism, we have experienced unanticipated turnover. We are working with our on-site officer to step up his patrol to help deter future instances of crime. We have also met with the city crime-free officer. Police tape with “STAY BACK” makes it hard to show units.

C. We are currently auditing the resident files, and have found several errors and unsigned leases.

D. Reorganization of the office has been completed. Resident files were not in filing cabinets, and the office was in disarray.

E. Maintenance shop has been cleared of trash and broken furniture. Maintenance parts have been inventoried and organized.

F. Upon take over we found that nothing had been entered into the computer system for two weeks. We consequently updated the January activity and completed your month end close out.

Summary of Costs:

\$104,800

Estimated Management

Neglect

Unpaid Bills at Turnover to Us	\$110,800
Negative Cash Flow Months 1-6	<u>\$100,000</u>
	\$315,600

Monies Needed from Ownership

As you can see, there are many issues and adversities facing us with probably more to come. I feel the majority of the issues have been identified and we have plans for each to be corrected. We will keep you updated. We need to talk about funding these issues.

Sincerely,
Ken McElroy
President

As I mentioned earlier, it took us nearly an entire month to put this letter together. We had to audit every file on the property, walk every unit, and inspect every aspect of the building exteriors. We are talking about major man-hours. All the result of bad management.

In addition to the challenges that my management company faced with the operations of the property at takeover, we also had to deal with an ownership that was uncooperative and hostile toward us. The reason for the hostility stemmed from the bruised egos of the ownership. Unfortunately, they had no idea of the magnitude of damage that had been done to their investment. Once we finally compiled all the information and presented it to them in monetary form, denial began to set in. Instead of wanting to take responsibility for their poor management decisions, or lack of any management at all, really, they chose to ignore our feedback.

The labor involved in meetings, working with subcontractors, interacting with residents, rehiring and retraining staff, holding conference calls, faxing and e-mailing, doing projections, spreadsheets, and budgets, *and* dealing with very upset and unpaid vendors was a huge strain and a mental drain on me and my

staff. Oh, and by the way, my company did all this for about \$3,000 per month in fees. That's less than I pay my assistant.

The ownership had let the accounts payable slip into the red until the hole was too big to dig out of. And a constant point of contention was the fact that it would not give us the money to pay the outstanding payables amassed for services rendered before we even took over the property.

The managing ownership delayed the inevitable and blamed "new management" (my company) for lack of cash flow. What was even worse was that it was not communicating any of this to its investors. Who wants to tell investors who have placed millions of dollars with you that you royally screwed up and lost the money? It's much easier to live in denial and place blame on someone else, which is exactly what they were doing. And because of the fact that the managing owners were not communicating with their investors, the investors were calling us with lots of questions. This placed even more stress on the relationship between my company and the managing ownership.

As I mentioned, the managing ownership would not provide the money necessary to pay the outstanding bills. Even worse, because of the precarious financial state of the property when we took over, it became apparent that we wouldn't even have money to pay staff salaries and the property's mortgage. Finally, because the ownership was not willing to relinquish the money needed, even though they were contractually bound to do so, we exercised our contractual right to go around the managing ownership and call all the investors ourselves, asking them for *more* money on top of what they had invested to pay the accounts and payroll. This did not go over well as you can imagine, and, once again, rather than taking responsibility as they should have, the managing owners fired my company.

The next management company they hired lasted six months. At which point, the state of the property was so completely beyond repair that they had to sell the building at a significant loss.

Did you catch the reference to the murder in my letter to the ownership? That too was a direct result of bad management. The prior management didn't screen their prospective residents properly and thus allowed criminal elements to slowly creep in. The murder was a professional hit according to the city crime unit. It was a horrible reminder that without good management, even a good property in a nice location can become an eyesore—and a danger—for the community.

Beyond the condition of the property itself, we assisted the ownership in settling an overpayment in sewer fees to the city to the tune of \$35,460. The

property had sixty-eight units demolished to make room for a highway, and the sewer billing was based on a cost-per-unit basis. The existing owner had not thought to inform the city that the number of units had changed due to the demolition and had been overpaying their sewer bill for forty-two months.

What is worse, we discovered that even before the demolition the city had been billing the property for 280 units. The property was only 268 units before the demolition. They had been doing that for forty-nine months. All said and done, the property had been overbilled continually on a monthly basis by the city for ninety-one months—seven and a half years!

Many in my company jokingly refer to this property as cursed. The truth of the matter is that no property is cursed, only mismanaged. No matter the size, a property that is managed well, will perform well, and grow in value.

The irony of this situation is that although the managing ownership was in denial about the situation they micromanaged our every move. Cash was tight and their problems became our problems. In the end, being frustrated with us for constantly asking for money to fix the property, and with themselves for constantly avoiding their investors, we developed an adversarial relationship and soon parted ways.

The Problem Renter

If your primary investments are in smaller rental properties like single-family houses or duplexes, you might be thinking, “Sure, the decision to hire a property manager is a no-brainer when it comes to large buildings like the one in the previous story. But how does that apply to me? Do I really need a property manager for a house or a duplex?”

Many times I talk to people who feel that professional property management is something that only makes sense for people who own big apartment buildings—for professional investors that have the money to hire a company. That couldn’t be further from the truth.

Those same people tend to think that they should manage their rental house themselves. It’s no big deal they say. How hard could it be to collect rent! Boy, are they in for a surprise. Managing any property is time-consuming and demanding no matter what size it is. The reason for this is just as I said earlier. Size doesn’t matter. The same principles always apply. You have to find renters, collect rents, perform maintenance, complete capital projects, take legal action—the list goes on and on.

This is not to say that you can't manage your own property, and that you can't do it successfully. Many people do. But more often than you might expect, people wander blindly into managing their own properties, and often with disastrous financial results. It's not that they are dull or incompetent. I've known many brilliant people that have horror stories when it comes to managing property. Rather, it's often a fundamental lack of understanding of the basic principles that can lead to disaster. Usually, this doesn't come in the form of a major catastrophe. Instead, one little mistake leads to another, and another, and another—and, well, you get the point. All these little mistakes add up to one major mess. In the end, most amateur investors rationalize the situation by placing the blame on the real estate and that it was just “a bad investment.”

I'm not speaking in generalities. My in-laws bought a house in Washington state as a rental property. The house was at the end of a cul-de-sac in a nice neighborhood consisting of mainly home owners. It was a good size with four bedrooms and three bathrooms, so they usually rented it to families. They bought the house in the early 1980s for about \$70,000, and today it is worth about \$350,000. In that respect they have done very well with the house as an investment. They even had pretty good luck with renters for the first ten years or so, with only minor damage to repair here or there, and not too many challenges in collecting the rent. But all that came to an end when they met the “problem renter.”

I had the opportunity to sit and have dinner with my in-laws and discuss with them the experience they had with their house. They are wonderful, warm, and intelligent people who faced an overwhelmingly difficult situation regarding their rental property—a situation that was unfortunately nobody's fault but their own. We spent over two hours talking about the heartbreak and the challenges that they faced with this house and this renter.

My in-laws found the problem renter, we will call him Ross, through an ad they placed in the paper. They went through the usual process they used when assessing a potential renter. They performed some reference checks and had a personal meeting with him. Right up front he said that he'd just filed for bankruptcy, but because my in-laws are very nice people they still felt compelled to rent to him. Here's how my mother-in-law put it: “They were you know good Christian people and they did go to church and their pastor co-signed for them. We required that. And he did. Ross's brother was in jail, and he and his wife were taking care of his two kids, and they were living in an apartment. Ross and his wife had two small children of their own at the time. And the sob story was

they needed more space. Well, that's where our hearts took over and we rented to them... I think the bottom line is that we really made the mistake of not checking. Although I think we knew that we had taken a chance, but the fact that here they were taking care of his children and his brother's children and they needed the space. We just made a huge mistake.”

Immediately Ross's deposit check bounced. He had a story for that too. (They always do, by the way.) Still, my in-laws continued to cut him slack. Here's how my father-in-law summed it up: “He always had some story for it, which even I believed initially. You know you don't want to kick somebody out right away. We didn't really have a big problem with the rent initially back then. I laugh about it now, because the biggest problem was that we didn't get the rent on time. Compared to what we went through later, it was not that bad. And when we would go down there to visit, the house was always clean, always looked good. Initially.”

By now you are probably sensing that as the situation developed, late rent was the least of their concerns—and you're right. Eventually, Ross started not only paying late, but not paying at all—\$15,000 in back rent when all was said and done, over nineteen months' worth of rent.

On top of all that, Ross was a self-proclaimed handyman, who had worked as a carpenter and as a landscaper. Without the permission of my in-laws, he began to initiate projects around the house that he deemed to be improvements. Not necessarily a bad thing, except that he never finished any of them. Over the course of time that he was in the house, Ross had started the following projects:

- Completely tore out the front and back yards, including retaining rockeries on both sides of the backyard, causing damage to the neighbor's yard. He also accidentally knocked the deck of the back of the house.

- Removed every interior door in the house.
- Removed every baseboard in the house.
- Removed all kitchen cabinets and all kitchen appliances.
- Tore out all bathroom vanities.
- Started to install a Jacuzzi.
- Expanded a closet into the garage, making it impossible to park a car in the garage.

- Demolished a wall in the downstairs utility room because he wanted a bigger bathroom.
- Removed all carpet in the upstairs in order to lay down hardwood flooring.
- Started rounding corners on all walls.
- Started installing an oversized shower in the downstairs bathroom.

None of these projects was overseen by a licensed contractor. Consequently, there was a host of plumbing and electrical issues to be dealt with, as well.

Beyond all of these issues, Ross had also stolen money from my in-laws.

“This happened the summer that we finally got him out of there,” says my mother-in-law. “I finally said, ‘We need to go find out where the rest of these landscape blocks are that had been in the backyard,’ and so we went up to the business where we paid for the blocks. And after some head scratching and ‘No, I don’t remember,’ the block company finally found that Ross had actually come in the summer before and returned the blocks for a refund of over \$600.”

You might be asking yourself, “How could they let this happen?” My in-laws are by no means novice investors. They own four properties in the Seattle area, and until the problem renter they managed the properties themselves while living in Scottsdale, Arizona, part of the year. They make a point of saying that until the problem renter they never really had any issues, but that is more from the luck of the draw than from calculated strategy. In fact, it was their lack of sound property management fundamentals that landed them in this very grave situation. They suffered from “hold on and hope it gets better” disease, which makes you believe that someone will change their behavior *this* time regardless of an established pattern of past behavior. It almost inevitably starts out sounding a little something like this: “But, when somebody has been renting for years and paid you over \$100,000 in rent, you cut him a little bit of slack, knowing that he was capable of doing good work if he would just focus on it. We tried our darndest to try to get him to focus on some of these projects to try and get them done.”

And it always ends sounding like this:

“But that turns out it was too much to hope for. It became very obvious in the last year and a half that things were not going to get done. The only way they were going to get done was for us to get him out of there and finish them ourselves, along with the help that we hired. Once we came to that conclusion,

then the effort was directed at getting him out of the house.”

My in-laws ended up hiring a property manager who was responsible for evicting Ross from the house. The damage, however, was already done. And in the fall of 2004, they came out of retirement and traveled to Seattle from Scottsdale to begin repairs on the house.

They had to enlist the help of two friends as well as a contractor. It took five people in all to do the work needed. Those five people worked every day for six to eight hours from September until November in order to get the house livable again. Three months of their retirement were gone.

All said and done, the costs associated with their decision to rent to Ross

Back Rent	\$15,000
Repairs	\$55,000
Not raising rent in nine years	<u>\$40,000</u>
were: Total	\$110,000

Pretty unbelievable, huh? The most amazing part is that my father-in-law had only paid \$70,000 for the house when he bought it. Expenses stemming directly from poor property management had cost him over 1.5 times the original cost of the house. Ouch.

Beyond the economic impact, however, there were deep emotional costs. This is important to understand. My in-laws had to deal with not only their own emotions, but also those of their tenant and his family and the neighbors, who had contacted the city and every government agency in attempts to get them removed. They found the stress unbearable at times. In the end, my in-laws were very much affected by the situation, both individually and as a couple.

“That’s the only thing that we ever fought about,” says my mother-in-law. “Ever, ever, that I can think of. And I mean we had some shouting matches over it. I know it was hard on my husband because he kept everything inside and I’d blow everything out. And I wanted to talk about it. And he didn’t want to talk about it because it was unpleasant. It was terrible, terrible.”

Over the course of many family get-togethers, I heard this story unfold. It was a constant source of stress and emotional turbulence for my wife’s parents. That was one of the hardest parts for me to watch.

They would ask me for my advice, but would not act on it. It’s not that I was any better than they, but I had over twenty years of experience running companies that dealt with situations exactly like theirs. I knew what needed to be done, but only they could do it. And when they finally did, it was much too late.

Chapter Two

Property Management Systems

In [Chapter One](#), we explored two stories that examined the horrors of not following sound property management principles. You're probably wondering, what are those "principles?" That's what we'll discuss in this chapter. There are many lessons to learn from the two stories.

These are common threads that run through both stories:

- Both owners lived in an area other than where their rental property was, yet chose to manage the property themselves instead of enlisting the help of someone who had knowledge of the market and could keep a constant watch on the investment.
- Both owners had poorly-formed systems in place in which to manage their property effectively.

Out of State, Out of Mind

It is almost never a good idea to manage a property yourself if you do not live in the area. In any given market there are a multitude of details that you couldn't possibly know unless you specialize in that market. These issues could be legal, submarket-related, local relationships, weather patterns, and more. It is always preferable to hire someone who is local, and who knows the lay of the land intimately.

I own a property in Oklahoma. My company specializes in property management, managing over 8,000 units. Do you think that I use my company to manage these properties? Not on your life. We are based in Scottsdale, Arizona.

The time and effort required to set up successful operations in Oklahoma would be a huge waste of energy and money.

Here's what I did instead. I developed a team.

In my previous book, *The ABCs of Real Estate Investing*, I talk about the necessity of building a team. In real estate there is nothing more important than building a team. I used mine through the entire process of acquiring my Oklahoma City building. I enlisted a local broker to find the property and provide detailed market data. I used my attorney to draft and review legal documents like the purchase and sale agreement. I used the due diligence team from my company to explore every square inch of the property before we bought it. If you think you can do real estate by yourself, you are sorely mistaken. Experts will always see details in a minute that you or I would totally miss.

In the case of my Oklahoma property, I decided to hire a property management company to manage the property for me. Why? While I did my homework in purchasing it and have a pretty good idea of the market now, that data might be no good in a couple of months. Markets are constantly changing.

Not only is the market of Oklahoma City constantly changing, but the property's location is a submarket within the market, and that submarket is constantly changing. In the southern part of the city there might be concessions because of low occupancy, but in the north, occupancy might be high and there would be no specials. Could you imagine if I just Googled rentals in Oklahoma City from my computer in Arizona and saw that there were specials in the market and decided to apply them to my property in the north submarket where there were no specials? I might as well just stand out on the street and hand out money.

When you live 2,000 miles away it is impossible to keep up on all the minute and shifting details in a market. That's a headache I don't want. Look at both the properties from [Chapter One](#). In those cases, rents were well below the market because the owners lived too far away to have a clear picture of where the market was moving. Because of this they lost valuable income-producing opportunities.

When we took over the property mentioned in [Chapter One](#) located in Arizona it became clear right away that we needed to raise rents on the three-bedrooms. They were \$45 under market, and there were 50 three-bedroom units on the property. That's \$2,250 per month in lost income, and \$27,000 a year! Additionally, we found that in the property's submarket it was common practice to charge more for ground floor units. We increased the rents by \$25 on those.

On 100 units that equals \$2,500 per month in lost income, and \$30,000 a year! After we instituted these increases, the Arizona property was collecting on additional rents at \$57,000 per year.

To figure the value of a property based on its net operating income—that is the income after operating expenses—we use something called a capitalization rate. It's really not as complicated as it sounds. Here's the equation:

$$\text{Net Operating Income} / \text{Capitalization Rate} = \text{Property Value}$$

More often than not you can get average capitalization rates for an area from a local broker. Let's apply this concept to the lost revenue in the case of the 200-unit property and find out how much a little mistake can add up to a major loss.

Let's say the average capitalization rate in the Phoenix submarket is 6 percent, and let's take that capitalization rate and apply it to the lost revenue of \$57,000 from not raising rents to market.

$$\$57,000 \text{ (lost NOI)} - 6\% \text{ (capitalization rate)} = \$950,000 \text{ (lost property value)}$$

Just think, if the owners had decided to sell their property instead of hire us to manage it, they could have lost out on almost a million dollars based on their "little mistake" of not keeping up with the market rents. If that won't put the fear of the property management gods in you, I don't know what will.

The last thing I want is to miss opportunities for profit on my Oklahoma City property. That is why we hired a local expert on the apartment market to manage our valuable investment. There is no way I'd presume to think that I could manage it effectively from my office in Scottsdale.

Nuts and Bolts

In my introduction I said that property management is a down-and-dirty business. It's true. Real estate investments are not neat and clean like stocks or bonds. They are not paper that just gets moved from one account to another. They require you or someone you hire to roll up your sleeves and get your hands dirty. What do you think property management involves?

Here's an interesting exercise. Take a moment before you continue reading this book and get a paper and a pen. I want you to write out a list of everything you think is involved in managing a property. We'll call this the nuts and bolts—the things that are required to make a property run smoothly and efficiently.

Make it as detailed as possible. Then, add the time you think it will take to do all the things on the list and how frequently you think you will have to do them.

Now, I'll show you my list. When you are done reading this section pull out your list and compare it to mine. Most likely there will be some significant differences between your list and mine. But then again, maybe there won't be. In which case, you probably can put this book down. Thanks for buying it, but sorry, no refunds. For a majority of investors, however, there is a gross misconception of the time, effort, and work that is involved in managing a property.

Residents

It has been my experience that the number one fear of any investor is dealing with residents. This fear is understandable. Numbers are easy, people aren't. Chances are you are a nice person. You don't like to be confrontational. Most people aren't. Your first impulse will be to give that person an extra week to pay the rent or not charge them for painting after they have moved out. This stems from fear. It is easier to just let it fly, rather than confront the situation. Well, I've news for you. In order to be an effective property manager you have to confront issues head-on and with confidence. Some residents are like sharks—they can smell blood in the water. If you are not sure of your position, they will eat you alive.

You are an unwelcome presence in the life of most residents if you are a property manager. Think about it. All of us probably rented at one time or another. What were your thoughts when the manager knocked on the door? "Oh, they must be coming by for a friendly chat. Maybe I should put a pot of coffee on!" Hardly.

Let's not kid ourselves. Residents know the less they see their property manager, the better, because the truth is we are generally the harbingers of bad news. When we come by it is to address a complaint, or collect late rent. It is not for a chat—though a cup of coffee would be nice every once in a while.

If you are not willing or able to really assert yourself, and most people aren't, your property is really in for it. Remember the story of my in-laws' house? All of their problems stemmed from the fact that they were afraid of confrontation. In retrospect, here is what my father-in-law had to say about the situation:

"One thing, in hindsight, and it's real apparent, if you sense that there is a problem, and you start getting bounced checks and things, you need to move on

it. Pronto. And nip it in the bud, and if that includes evicting them, then so be it.”

That’s good advice from someone who learned it at the school of hard knocks. But here’s what his wife had to say to her husband about that: “I think that takes a different kind of person than you are.”

Ouch. In considering whether to manage your own property, you have to be honest with yourself. If you are not the kind of person that can evict a family from your property, then you are not the kind of person that should be managing it. Even more, through the course of time some residents may actually become your friends. Can you evict someone that you had beers with two weeks ago? Thankfully my father-in-law eventually wised up and hired a property manager.

The biggest part of property management is interacting with residents. Everything else stems from that. Just some of the many things that you’ll have to do involving residents are:

- Find them
- Collect rent/fees
- Be a sounding board for them
- Address their maintenance issues
- Enforce policies and contracts

If you own a building that has more than one rental unit, you will have to deal with resident-to-resident issues as well. Inevitably residents will have disputes with each other. Will they handle these issues themselves? Sometimes they will, but often they bring these issues to you. Very rarely will you be able to make both sides happy, so know that you will always have someone that thinks you’re a jerk. That’s the way it is.

When I was younger and still managing properties on-site, I had a memorable experience with resident-to-resident issues. The incident involved neighbors. A single guy was sleeping with the neighbor’s wife while the husband was out working. It turned out that the single neighbor had a venereal disease and had passed it on to the wife. Even worse, the wife had then passed it on to the husband.

“That’s their problem,” you’re probably thinking. Well, they didn’t think so. The husband demanded that I evict the single neighbor. What would you have done? Can you imagine the range of emotions that each party brought to the table? As I’m sure you know, I couldn’t do anything. No one had broken any

contractual obligation or rule. You can't evict people for being stupid. Needless to say, the husband was not satisfied with this answer.

Maintenance

I have seen situations where the lack of maintenance is unbelievably appalling. A client of mine purchased a building in a foreclosure, and we were doing an initial walk of the property, inspecting each unit, before taking over management. During this inspection, I walked into a unit where a fifty-year-old woman was living. She had lived there for many years. There were stacks of newspapers from floor to ceiling, and food and trash were lying out in the open covering every square inch of the floor. As if that wasn't enough, there were roaches. And not just a couple. There were so many roaches that it appeared as if the walls were moving. I'm not exaggerating. Thousands of roaches had infested the entire unit and this little old lady was living in the midst of this filth and decay.

Not only that, but when we examined the kitchen we found out that her fridge wasn't working. She clearly had no sanitary place to store food and that explained some of the smell. On examination of the cupboards we found a bird living in them. The bird had actually pecked away at the side of the building and had burrowed its way into the cupboards from the outside. Who knows how long it had been there.

Clearly, this is on the extreme side of deferred maintenance. But it's important to note the problem with a resident like this is that they affect the rest of your residents too. Roaches don't stay in one apartment. If you want to get rid of roaches, you have to spray that unit, and all the units adjacent to it. From an owner's perspective that is a lot of extra cost.

It is imperative that you have sound systems in place for maintaining your property. Maintenance is the single most time-consuming and expensive aspect of owning an investment property. It is often the reason that residents move out of your property as well. If they are not happy with the level of service provided by you, then they will move on down the street.

Think about it. What if you were living in a community and you wanted to throw a dinner party? Only one problem: the toilet is out in your unit. You submit a work order a week in advance. You then get to living your life. You plan the menu, clean the house, do the grocery shopping, and so on. On top of this you are, of course, still working, and trying to get some leisure time in.

About a half a week rolls around and the toilet isn't fixed. So you call the manager or owner. "Oh, sorry," they tell you. "We've been really busy. But we'll send someone over today." But nobody comes over.

You call again the next day. Now you're starting to get irritated. They promise to have it fixed, and you tell them it's important because you are having guests over that weekend. They promise that they will have it fixed by then. Meanwhile, the toilet is sitting stagnant, and it's starting to smell pretty bad.

Finally, you have your party and nobody has come to fix your toilet. You'd be understandably upset, right? Given a common scenario like this, how inclined would you be to renew your lease when the time comes around? One bad experience is usually enough for most residents to at the very least start shopping your competitors, and more than likely to move.

In the case of the stinky toilet, the property management's inability to implement efficient maintenance systems would cost them dearly when you moved. They would have to turn the unit, experience lost rent income, and pay to advertise for a new resident. All of which is much more expensive than to call in the plumber or send the maintenance technician.

Deferred maintenance can also severely affect the value of your property. Think about my in-laws' house. That too was an example of deferred maintenance. They should never have been in the position that they were in when the problem renter moved out. They should never have relied on a resident to "take care" of their investment.

Do you remember how much they had to spend just to get their property back into a livable condition? \$55,000 in repair costs. That doesn't even include the value of their lost time. The deferred maintenance on their house had severely devalued the property to the point where they couldn't even sell it if they wanted to. And they tried. Once they had assessed the amount of damage and the work it would take to fix it, my in-laws attempted to sell the house "as-is" at a significant discount. Two different potential buyers ended up walking from the deal because the amount of work that would have been involved far outweighed any potential savings to be gained. My in-laws were stuck and had no choice but to complete the work themselves.

Deferred maintenance was also a huge issue when we took over the 200-unit property. So much so that we fired the entire maintenance staff. Let's review the letter I drafted to the owners. The issues were:

<i>Item</i>	<i>Cost</i>
40 units had to be turned or made rent-ready	\$50,000
59 service requests were outstanding	\$20,000
Roof leaks throughout property	\$30,000
Patios needing repair	\$2,250
Two HVAC fan motors replaced	\$550
Tennis court fence needing repair	\$2,000
Unpaid bills	\$110,800
<u>Negative cash flow</u>	<u>\$100,000</u>
Total cost	\$315,600

These costs would not be directly translated into a reduction of the same amount in the purchase price of the property if the owners had chosen to sell. The cost would have been much more. The buyer would have been looking at not just hard costs, but lost revenue from units being down for a month or more already estimated nearly \$1 million in value just on the three-bedrooms and ground-floor units! All of this would have been taken into consideration, and a buyer would have a lot of bargaining power with the owner to drive down the purchase price.

Given all this, doesn't it seem absolutely essential to have tight maintenance systems? You have to be diligent to forge relationships with plumbers, electricians, HVAC technicians, and others. Would you be confident that if you needed a plumber to go out to your property at nine in the evening, you would know exactly who to call?

Similarly you need to have a way to log all the work orders that your residents call in. Are your files a mess, or are they immaculate? Can you verify and keep track of the time you've spent on each unit? The cost?

Something else to consider is that established property management companies have relationships with maintenance vendors and can contract work at a much lower rate than the general public. Even more, they have the ability to be bumped to the top of the list when it comes to responding to emergencies. We call this economy of scale. If you owned a plumbing company, who would you be more motivated to service, and service at a discount, an account that represents over 1,000 apartments, or someone who owns one rental house?

Maintenance is also what people bring up as the most distasteful part of property management when I talk to them. I haven't met too many people who proclaim the joys of toilet cleaning. Do you? Taking care of your residents'

maintenance issues will draw you out of your home at all hours, and take up a significant portion of your time. Whether you like it or not, your residents look to you to be timely and accommodating to their schedules, not your schedule, when it comes to fixing their homes. They are in fact paying for this service. Your properties' success will depend heavily upon how well you understand this concept.

Rich Dad Tip

In property management, your resident's schedule will be your schedule.

Vacancy, Turnover, and Leasing

Vacancy, turnover, and leasing, much like maintenance, are continual time-and-money-eaters. In fact, I would venture to say that money and time lost from vacancy will be the biggest stress point of managing your property. If it takes you two weeks to get a place rent-ready you have lost two weeks of potential income. As a property manager it is essential to have systems in place for turning a rental quickly and efficiently.

First off, you have to be able to assess the condition of the unit upon the move-out of the resident. It would be wise to have a form to fill out. I do this in my company. We use an NCR inspection form so that we have multiple copies of the condition report. You can go onto my Web site, KenMcElroy.com, and see an example. We fill out this form when the resident moves into their unit and have them sign it, and we do the same when they move out. I cannot stress enough the importance of documentation.

If you just wing inspections the chances that you will miss something (possibly something very costly) are great. Beyond that, if you have a dispute with a previous resident over damage to your property and haven't documented the history of the unit, you're not going to have a leg to stand on legally. One thing that we do is take pictures at move-in and at move-out. Photo

documentation is a very powerful tool in protecting yourself—it's very hard for a resident to argue they aren't responsible for damages when you can produce photographic evidence. But they still will!

Once you have assessed the condition of the unit at move-out, you have to do two things:

1. You have to determine how much, if any, of the resident's security deposit you are going to refund.
2. You have to line up the work that is needed on the unit.

Maybe the unit needs to be painted and the carpets need to be cleaned. Are you going to do this by yourself or hire outside help? Either one will take time and money. How much exactly we will examine in a future chapter. Just know that it's not a little, it's a lot. Also, keep in mind that during this entire time, you are losing money due to lost rent because the unit is vacant.

This is especially true if you had a family occupying your property. I know firsthand how true this can be. I remember the two years when my family and I were living in a townhouse while we were building our dream house. Our plan was to rent the unit after we moved into our new home.

We have two sons. At the time, one was nine and the other was six, and both were full of life. That is a nice way of saying they were pretty much out of control the majority of the time! If it wasn't baseballs flying into Sheetrock, it was boys slamming into walls while wrestling. Kids will cause all kinds of damage. They will create beautiful artistic masterpieces with crayons on your walls. Posters will be pinned into walls, and staples will hold up arts-and-crafts projects.

If you have kids, especially boys, you know exactly what I'm talking about. After a while, all the roughhousing, coming in from the outside muddied up, accidents, and general mayhem add up to quite a bit of damage. When we moved out, the entire townhouse required patchwork. The walls needed to be repainted. (There's nothing like greasy handprints to add to the ambience.) The carpets in my sons' rooms needed to be replaced, and the whole house needed a thorough cleaning. All this "little stuff" added up to a lot of money. All said and done I was \$4,000 out of pocket.

The cost to turn a property is tangible. You can see how much you are spending. You can feel the pain in your pocketbook as you write more checks. Often overlooked, however, is the cost that comes from lost income while the

unit is vacant. Take my townhouse for example. All the work that needed to be done took a month. Then finding a resident took another month. The market rent for that type of townhouse is roughly \$1,500 per month. That's \$50 a day in lost revenue!

I hired out all the work on my property, and it still took that long. Those two months of vacancy cost me \$3,000 that could have easily snuck up and bitten me like a snake if I hadn't been prepared. Can you imagine if I had been trying to get it rent-ready by myself, on top of work and all my other responsibilities? It might have taken me three or four months, and all the while I would be losing \$50 a day.

Obviously you can see how important it is to make the process of turning a vacant unit as expedited as possible. There is an old saying that goes: "Sales solve all problems." The same holds true for leases. The quicker you can get into your vacant unit, document what needs to be done, take care of any legal issues, complete the turn work, and re-rent the unit, the better.

This is where professional property managers have a huge advantage over owners who manage their own properties. When it comes to leasing, professional property managers have established client bases, deep advertising connections, and a network of other professionals who frequently refer potential residents to them. You will never have better buying power than a large property management company.

That is not to say you cannot be successful at leasing your property if you manage it yourself. It will just inevitably be harder and more expensive. If you are managing your own property, there are definitely some practices that you should adopt from the pros.

Always do a thorough background check. I can't stress this enough. If you don't use a standard rental application, you can review one on my Web site, KenMcElroy.com. You need to have one that requires Social Security numbers, work history, and rental history. It's worth the time to subscribe to credit check companies that run credit and criminal checks on your applicants so that you know exactly what you are getting into. Don't just meet with someone and go with your gut feeling as my in-laws did. If you do, the only feeling you'll have in your gut is hunger because of all the money you'll have to shell out. The best part of credit check services is that you charge the potential resident to run their own credit report! Something we call a pass-through. In the end, there is absolutely no expense to you. You have everything to gain and nothing to lose.

This was the first mistake that my in-laws made when renting to Ross. When

I asked them what background checks they did, their response was, “We didn’t check everything. But we ran a few checks to satisfy ourselves that they were fairly stable.” When I pressed for details, it became clear that they had only talked to some of the references that Ross had listed on his application.

Often, sex offenders and potential residents with criminal backgrounds will be the nicest people you have ever met. This is because they have a past and want to gain your trust. Most avoid professional management companies because they will run background checks. Once these residents are moved into a community, they are the hardest to get out because they know how hard it will be to get another apartment. Their behavior can often drive out other residents, and they will ignore your legal notices. Often, you will have to forcibly remove them.

In the case of my in-laws, their neighbors actually brought a lawsuit against them because the property was in such disrepair that they were concerned it was devaluing their property. Letting bad-profile residents into your building will affect the value of your property in a negative way and will be an expensive problem to fix, not to mention the lost time and emotional distress you’ll experience.

Unfortunately, people lie. That is the brutal truth. Thus it is always in your best interest to have every detail of an application investigated by a professional organization. It’s been my belief that most potential residents with shady backgrounds will be so put off by background checks that they will take an application, leave the office, and you will never hear from them again. Just implying that you will be running a background check will deter 90 percent of the applicants who have a less than stellar background.

Laws—Federal, State, and Local

The most important, and often most overlooked, aspects of managing a property are the legalities involved in dealing with both your potential residents and those that already reside in your property. Like a snake in the grass, legal issues can come up and bite you before you even see them coming.

I’ve been managing properties for over 25 years, yet I never presume to know every law and rule. I work with professional attorneys who have been essential to my success. I defer to their expertise. My company and other larger companies have accounts with real estate attorneys so that if any legal issue should arise, they are ready and waiting to handle our problems efficiently and

effectively.

Two attorneys I use frequently in my business are Denny Dobbins and Scott Clark. I've had a relationship with both their firms for many years. So it was only natural that when I was getting ready to write this section, I once again deferred to their expertise. I owe both men a debt of gratitude for their help and support in writing this section. If you own property in Arizona, I highly recommend either one for your legal needs.

A lot of investors don't think that they will ever really have need of an attorney or that they will face any legal issues regarding their property. Don't be fooled into believing this. If you own rental property the chance that you will run into legal challenges is very high. It may be something as simple as eviction of a resident or it might be something more serious like a lawsuit brought against you by a resident. Denny and Scott handle a combined 1,500 to 2,000 legal issues regarding property management every month! That is over 24,000 a year, and that is only two law offices. Though only a handful of these ever make it to trial, the majority of the cases that do go to trial involve small properties and owner-managers. Once a case goes to court you're going to have to start writing a lot of checks.

In talking with both Denny and Scott it quickly became clear that there were distinct differences between the types of interactions they have with professional property management companies and with owner-managed properties. For both firms, dealing with professional companies is a much more streamlined process because they do not see the, for lack of a better term, amateurish mistakes that owner-managers make. As Denny Dobbins put it, "For large companies, legal issues are ready, aim, fire. For mom-and-pops, it's ready, fire, aim."

Right away let me make clear that the fact that owner-managers represent a majority of the complicated and avoidable legal cases in no way means that owner-managers are stupid or somehow deficient. Rather, it brings home the fact that the laws and ordinances in any given area are complicated and nuanced. The average person simply doesn't have the capability to keep up with changing laws or to effectively interpret them. And when it comes to the legalities of property management, ignorance can be costly.

By way of example, ask yourself this: Do you know your state's Landlord Resident Act? Would you even know where to find it?

Even seemingly simple procedures can become major issues if you handle them wrong. For instance, if you need to evict a resident, how many days' notice do you legally have to give in your state? How does that notice have to be

delivered? What are valid reasons for evicting someone? If you don't know the answers to these questions you could be in serious trouble. An eviction that is handled incorrectly can cost you a lot of time and money—and in the end you might not even be able to evict the resident, even if the reasons were valid. For both Scott and Denny, a majority of cases that go to trial arise because of someone's ignorance or misinterpretation of the landlord laws.

A story that Scott Clark shared with me is an excellent example of how easy it is to misinterpret landlord laws. One of his clients had a resident that lived on the second floor of a building and played his drums loudly at all hours of the night. Naturally, the other residents were frustrated by the noise and they logged innumerable complaints with the owner. The owner sent written notice to the man asking him to keep his drumming to a minimum and within certain hours.

Time went by, and the resident ignored the notice and continued to play his drums at all hours. Under pressure from other residents, the owner did what any of us would have probably done and sent the resident a notice of intent to evict. Seems fair and logical doesn't it?

Any one of us would want to get this guy out of our building, right? Well, it turns out the resident used to be a physician and had been brutally beaten outside a bar one night on his way home from the hospital. The assault had almost killed him. His face was horribly disfigured and he had lost nearly all his hearing. One of the only things he could hear anymore was his drums, and they had been configured and given to him as therapy.

The resident fought the eviction and the case went to trial. The jury ruled in his favor, saying that the owner had not properly tried to accommodate his disability. Under the law, the owner was under an obligation to do everything in his power to help the resident, and it was the judgment of the jury that he hadn't done that. In the end, the resident was able to stay in the apartment and the owner not only had to accommodate the disability, but was also stuck with hefty legal fees.

This is just one example of how not knowing information can create a legal nightmare for you and your property. If you are planning on managing your own property, it is imperative that you find a good lawyer for your team and actively take part in educating you and your staff, should you have one, on the laws of your state and locality. That being said there are some simple and practical things you can immediately do as an owner to protect yourself and your investment.

A SOLID LEASE

A well-drafted lease is essential for your protection. A majority of people have leases that are simply too short. I've even heard of someone that used to have new residents sign a lease on the hood of his car. It was basically a piece of paper with the rent and expiration date.

Remember, if it's not in the lease, it doesn't exist. For instance, if you don't have a clause in the lease that says your resident isn't allowed to have pets, you can't go back and tell them to get rid of their dog. The lease has to specify that *before* they move in.

Denny Dobbins has a lease for his properties that is twenty-two pages long. He has been perfecting it for over twenty years. My company has a lease that is similar. A lot of people are nervous to have a lease that is so long because they are afraid the resident will be intimidated by the length. Here is a secret: they won't read it whether it's two pages or twenty. The purpose of the lease is to clearly explain the expectations and the consequences of action for the resident and you.

Both Scott and Denny agree that a majority of cases that are lost in court are due to the fact that the lease didn't specify whether the issue in question was allowable or not. Now, you can't possibly cover every possible scenario in a lease—but you can try. Nothing is more empowering than asking a resident to read their lease (which both you and the resident should have signed and dated) when it comes to a dispute. You'll thank yourself for your foresight.

If you don't have a solid lease for your properties, you are heading for trouble. I encourage you to contact a local attorney and work with him or her to draft an acceptable document. It's important to realize that laws are different in various states and localities. You need a lawyer that specializes and works in real estate law in your area. They will be an expert on the local laws and can make sure you meet the needs of your property in the area that it is in.

DOCUMENT EVERYTHING

When it comes to interacting with your residents, clear and precise communication is the key. On my properties we keep resident communication logs. No matter the nature, we write down the details of a conversation with a resident and have them sign the log, agreeing that the details accurately reflect the conversation. This will save you a lot of grief down the road.

Here's a great example of how effective communication logs can be. One of

my properties has garages that can be rented for \$100 per month. Our policy is that you can add a garage to your lease even after you have moved in, but you cannot remove it until your lease expires. Recently a resident who had added a garage to his lease wanted to have it removed because he wasn't using it anymore. At first, he made a big stink and was yelling at the manager. But the manager was able to calmly pull the resident's file and show him the communication log with his signature that clearly stated he was informed when he rented the garage that he couldn't take it off the lease. Time and time again, documentation saves the day and defuses a potentially explosive situation.

In addition to a resident communication log, you will need to have any number of state-specific legal notices on hand. These would include things like eviction notices and notices of breach of lease and policies. The laws regarding legal notices vary from state to state so you need to be sure that you get the property forms from your attorney. Handing a resident the wrong form for an eviction notice can negate the entire process and cost you more money and time.

Don't try to write your own notices. A colleague of mine relayed a funny story involving a manager who did just that. The manager had set up a monthly pest spray service, commonly referred to in the industry as a "bug bomb." You know what's coming next, right? Knowing that they had to give residents notice of entry, the manager wrote a notice and posted it on the resident's doors that read, "NOTICE TO BOMB." Needless to say the phones were busy that day.

KNOW WHEN TO FOLD 'EM

One of the hardest lessons to learn as a property manager is when to swallow your pride and let a resident win a battle. If a resident is willing to go to court to dispute \$200, it will cost you \$1,500 in legal fees just to get it. Sometimes settling differences outside of court will save you a lot of money, even if you know you are right and can win.

If you rent to low-income and government-assisted residents, you should be especially aware of this. Low-income residents generally qualify for state-sponsored legal assistance, so there is no incentive for them not to fight you in court. They have no money at stake, but you do. Even if you win in these types of cases, many times you lose. A majority of the time, a resident simply won't have the money to pay you despite a verdict, and you will have racked up hefty legal fees.

LLCs—LIMITED LIABILITY COMPANIES

This is a no-brainer. Robert Kiyosaki, the Rich Dad team, and I always hit on this topic because it is so important. Keep all your properties in separate limited liability companies (LLC). An LLC is a legal entity that protects your personal assets should a legal issue arise with your property.

The advantage of an LLC over other legal entities is that it is relatively inexpensive to set up and there is little cost and effort to maintain one. Yet, when it comes to real estate, it provides the same kind of protection a corporation would. The procedures for setting up an LLC vary from state to state, and while you could certainly set one up yourself, I encourage you to contact your local attorney and work with them to make sure your LLC is set up properly and that you have every protection provided to you by the law. Another option is to pick up *Loopholes of Real Estate* by Garrett Sutton (www.sutlaw.com), a fellow Rich Dad advisor and an excellent attorney, who offers expert advice on the legal aspects of real estate investing.

Forms

As I discussed above, you should always document every aspect of your resident interactions. When it comes to your word versus your resident's word, you never want to have to say, "But I *told* you ..." Residents have an incredible ability to hear and remember only what is convenient for them. How could you really possibly remember every detail of every conversation you've had with your residents? There is nothing worse than the feeling of knowing you've been "had" by a resident because you didn't document a conversation or provide written notification.

Rich Dad Tip

As a property manager, one of the most empowering things you can say is "Read your lease."

There are many forms that you should have on hand at all times:

- Leases
- Addendums to the lease (e.g., pets, parking)
- Move-in/move-out forms
- Community policies and procedures
- Resident conversation logs
- All manner of legal notices (as discussed above, get these from your attorney)
- Traffic logs to keep track of potential residents

Samples of many of these forms can be viewed on my Web site, KenMcElroy.com. Also, if you are a member, you can get standard forms from your local multi-housing associations or from the National Apartment Association. These forms are guidelines. Each community will have its own individual needs. Make sure to adapt forms to fit those needs.

Rich Dad Tip

Always document everything when it comes to resident communication.

Chapter Three

Cash Flow Management

In *the ABCs of Real Estate Investing*, I talked about building a sound management plan. A sound management plan is simply this: reducing expenses and raising income. That's all there is to it. It really isn't rocket science. Your goal as an investor and owner of investment real estate should be one thing, and one thing only—to own a property that cash flows. Equity through market appreciation is just an added bonus that you have no real control over. If you bought correctly, the only power you have to effect change in your income potential is by managing your property so that it cash flows.

How do you know if you are reducing expenses and raising income? By reading an income/expense statement. If you are not adept at reading your property's financials, you'd better learn fast. Those financials tell a story about your property better than Ernest Hemingway could.

One excellent way to begin learning how to read an income/expense statement is through Rich Dad's board game, *CASHFLOW*. There are many things that I like about this game. One, it depicts real-life scenarios; two, it teaches you a basic understanding of reading an income/expense statement; and three, you are playing a game and learning. I used to play this game with my nine- and six-year-old kids all the time. If they can learn how to read a financial statement, you can too. The *CASHFLOW* game is an incredible tool focused on getting you to think like a true businessperson, and it's fun at the same time.

Your Property's Report Card

Think of an income/expense statement as your property's report card. Do you

remember when you were in grade school and the feeling you got when it came time for report cards to be sent home? Boy, do I ever. If you were anything like me, that was usually a time of dread and panic. I can still picture the teacher passing out the sealed manila envelopes, and the desire to hide it from my parents.

Why did I feel this way? Because I knew I would be busted. I wasn't applying myself the best that I could, and my grades reflected that lack of effort. Sometimes, in spite of myself, I still got a good grade. That was as much a surprise to me as it was to my parents. I had the feeling that I had gotten away with something, and that it would still come back to bite me.

I'm sure there must have been kids who felt just the opposite. As sick as it may sound, there might have been kids who were actually excited to receive their report cards. Kids who would skip all the way home, polishing their halos, because they were sure that the effort they put in was rewarded.

Grade school report cards are of course no measure of how successful you will be in business, but your property report card sure is. I can guarantee you that your banker will never ask you for your report card! When it comes to your property report card, which is your financial statement, you want to be just like those kids who were excited to run home and show their grades to their parents. You know that you are a successful property manager when you can look forward to reading your income/expense statement every month, knowing that the work you did will be reflected in the final grade.

A Passing Grade

One of the single most important concepts you should take from this book is this:

$$\text{Income} - \text{Expenses} - \text{Debt} = \text{Cash Flow}$$

A very simple concept, right? As a property manager, your number one goal in life should be to maximize your income and minimize your expenses.

Income and expenses are very much within your control. In my book *The ABCs of Real Estate Investing* I wrote about the importance of setting up a budget for your property. If your financial statement is your report card, then your budget is the *CliffsNotes*. It's important to note that you set your budget based on your property's past performance and the market's projected trends and then use the budget for your measurement of success.

Setting up a budget is not as difficult or daunting as it may sound. It is actually a pretty easy process and one that will instantly give you a feeling of control when it comes to making sound financial decisions regarding your property. It is the first step toward getting a passing grade.

The easiest way to begin setting up your budget is to look at the historical financial information of your property. It would be best to use Excel or some other type of program to lay out this data in a way that works for you. You don't need a fancy, sophisticated software package to do this. What you need is a thorough understanding of financial concepts. Expensive software packages are an added bonus of using a professional property management company, but they are not cost-effective for one property. In the end, the goal is simply to keep track and understand the financial activity of your property. This way you will be able to watch trends. I do this with all my properties. What I like to do is input all the data, income, expenses, and debt, and use equations to figure out the percentage change from year to year, like the chart on the next page.

What a great tool! Once you start to learn how to read financial, a chart like this will tell you many stories about your property, and most likely about the market your property is in. Let's look at a telling example from this chart.

Take a look at the line for "Other Income." Other income is the icing on the cake. It is all the fees that you should be charging for applications, administrative work, pet rents, and so on. If you aren't charging these fees, you are missing out on huge potential for the financial health of your investment. In the previous year, this property had collected \$66,953 in other income. Nothing to sneeze at. If you apply that to a capitalization rate of 6 percent, that is over a million dollars added in value to the property. In the current year, however, the property collects an astounding \$109,869 in other income! That is a 64 percent difference toward the positive variance, and over \$1.7 million added in value to the property. What accounts for the difference?

	<i>Current Year</i>	<i>Previous Year</i>
	<i>Amount</i>	<i>Amount</i>
	<i>% Change from Prior year</i>	
REVENUE		
Gross Potential Rent Income	\$1,754,800	\$1,678,938
Gain/Loss to Old Lease	(\$80,607)	\$(176,729)
Concessions	(\$34,706)	\$(21,250)
Other Loss	(\$46,033)	\$(51,731)
Vacancy	\$(158,758)	\$(131,863)
Effective Rental Income	\$1,416,231	\$1,297,364
Other Income	\$109,869	\$66,953
TOTAL INCOME	\$1,544,566	\$1,364,317
ANNUAL OPERATING EXPENSES		
Professional Management	\$46,337	\$47,727
On-site Management/Payroll	\$169,708	\$156,244
Administrative	\$39,704	\$38,254
Advertising	\$23,968	\$22,478
Tax and Insurance	\$161,419	\$144,976
Utilities	\$64,223	\$56,751
Repairs and Maintenance	\$72,769	\$60,860
TOTAL OPERATING EXPENSES	\$578,128	\$527,289
Net Operating Income	966,438	\$837,028
Capital Expenses	\$44,694	\$17,001
Income Before Debt	\$921,744	\$820,027
Debt Service	\$684,258	\$684,258
Cash Flow	\$237,486	\$135,769

When my company bought this property we did a thorough evaluation of their financials and realized that the property was not implementing RUBS, or Resident Utility Billing System. If you're like me, you're thinking anything that

has to use an acronym has got to be complicated. The good news is the concept isn't complicated at all, and the legwork is done by someone else.

At its core, RUBS is a very simple concept. A portion of the total water, sewer, electric, and gas utility costs, which historically are landlord expenses, are added to each resident's monthly charges. This is a relatively new system in property management, so it's not surprising that someone who wasn't in the industry wouldn't know about it. But that lack of knowledge was costing the owner over \$40,000 per year in income. What you don't know actually *can* hurt you.

Let's take a look at each one of the categories listed in the table above and examine how we can use those numbers to make our new budget for this property's coming year.

Income

	<i>Current Year</i>		<i>Previous Year</i>
		<i>% Change</i>	
	<i>Amount</i>	<i>from</i>	<i>Amount</i>
		<i>Prior year</i>	
REVENUE			
Gross Potential Rent Income	\$1,754,800	4.52%	\$1,678,938
Gain/Loss to Old Lease	(\$80,607)	-54.39%	\$(176,729)
Concessions	(\$34,706)	63.32%	\$(21,250)
Other Loss	(\$46,033)	-11.02%	\$(51,731)
Vacancy	\$(158,758)	20.40%	\$(131,863)
Effective Rental Income	\$1,416,231	9.16%	\$1,297,364
Other Income	\$109,869	64.10%	\$66,953
TOTAL INCOME	\$1,544,566	13.21%	\$1,364,317

The income section of your budget will take into account not just money that comes in, but it will also account for lost income.

GROSS POTENTIAL RENT INCOME

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$1,754,800	4.52%	\$1,678,938

Gross potential rent income is simply the maximum amount of rent your property could theoretically collect. In a perfect world, you would be charging the maximum amount of rent allowed by the market to each and every one of your residents and collecting 100 percent of that rent on the first of each month.

Rich Dad Tip

A seasoned property manager will immediately see that rents are increased.

It is important to keep track of gross potential rent income because it is an excellent way to evaluate whether you should raise rents on your property, especially when coupled with loss to lease evaluations, which we will look at next. But for now, let's focus on gross potential rent income and use our example to see how the information can help us form our new budget figure for this category.

First thing we will do is look at the previous year's number and compare it to the current year. Our handy chart tells us that rents went up by 4.5 percent over the previous year. That is a pretty good rate of rental growth. So naturally we should budget for 4-5 percent rent growth in our new budget right? Not necessarily.

Rich Dad Tip

Never assume the previous year's actual numbers will hold true in today's market.

Just because we had 4.5 percent rental growth last year, that doesn't mean we will this year. So what now? First thing we should do is conduct a market survey in order to make sure our rents are at the market level. This is a simple process, and one you should do on a monthly basis. In order to conduct a market survey, all you have to do is call or "shop" the properties that you compete with and ask them for:

- Current market rents they are charging for each floor plan. You should get the square footage of each floor plan, as well as the high and low prices they charge.
- Any concessions that the property might be offering. Concessions are the incentives that a property owner gives in order to entice renters, like a free month's rent.
- Any fees that they charge, or deposits, and how much. For example, do they charge an application fee? Pet rent?

Once we have this information we are well on our way toward setting a realistic number for our new budget.

Remember when I said that you need to have a team in order to be successful in real estate? Well, this is proof positive. You could spend hours on the Internet looking at market data, or you could do what I do: call your broker or another property manager. They will have all sorts of market data and reports that will be able to give you guidance in setting up your new gross potential rent income budget number.

In this case let's say that most of the information that our broker or the other property manager has sent over indicates that the experts feel that market rent will increase by 4 percent in the coming year. This coupled with the fact that during our market survey we found most of our competitive properties were charging rents comparable to ours, and in some cases charging more, gave us confidence that we can use 4 percent in our new budget projections. Typically, market rents are driven by supply and demand of apartment inventory and, of course, population and employment. These all need to be considered.

LOSS TO LEASE

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$(80,607)	-54.39%	\$(176,729)

Loss to lease is another concept that a lot of people find daunting at first, but is really quite simple. Loss to lease is the difference between your actual potential rent income and your gross potential rent income:

$$\text{Loss to Lease} = \text{Gross Potential Rent Income} - \text{Actual Potential Rent Income}$$

Actual potential rent income is exactly what it sounds like; it is the total amount that could be collected were you to collect every penny accounted for on your actual leases.

A lot of people get stuck here. They ask why there would be a difference between gross potential rent income and actual potential rent income. It's a good question. The reason for the difference is that even if you raise rents, you can't raise them on people who are already under existing leases, until their lease is up. There will always be some drag. For example, say we raise rents on our one-bedroom units by \$15 per month because a number of the properties in our market survey were charging \$15 more than we were. If a majority of our one-bedroom units are under lease, we will not be able to realize that money till we either re-rent the units, or renew the leases months down the line, even though it is reflected in our budget under gross potential rent income.

So, if Joe Cool is renting unit 101 for \$685 per month, and has ten months left on his lease, and we have raised rents to \$700 for new rentals, that unit will be reflected as \$700 per month in our gross potential rent income category, but as \$685 in the actual potential rent category for those ten months. A \$15 per-unit, per-month difference, or "loss to lease."

Budgeting for loss to lease can be a little tricky, but ultimately doable. First, you should take your rent roll out and account for all lease expirations for the year going forward. This will also be useful for managing your lease expirations. You want to make sure you have an even amount of lease expirations spread out over a twelve-month period. If you owned a twelve-unit building, you would want only one lease expiring per month, which provides you more stability through the year.

Because your monthly expenses are a constant, you can have a great annual income but still be in financial trouble in a certain month due to vacancy if you do not manage the leases. You want to be able to bring in enough income every

month to pay your monthly expenses. That is hard to do when you have four out of twelve leases expiring and potentially moving in a single month.

A rent roll is the list of all units, the residents that occupy those units, and the monthly rents that they pay. Once you have your rent roll out, you can use it to look at each lease and figure when in your budget you will be able to raise the rent to market level on each unit. Here is a sample rent roll for a twelve-unit building:

<i>Unit#</i>	<i>Type of Unit</i>	<i>Size/ Sq. Ft.</i>	<i>Potential Income</i>	<i>Actual Income</i>	<i>Resident</i>	<i>Lease Expires</i>
Unit1	1 bedroom	750	\$700	\$685	Haddon	May
Unit 2	1 bedroom	750	\$700	\$650	McElroy	June
Unit 3	1 bedroom	750	\$700	\$650	McCallister	January
Unit 4	1 bedroom	750	\$700	\$675	Brice	May
Unit 5	1 bedroom	750	\$700	\$700	Johnson	September
Unit 6	2 bedroom	900	\$900	\$825	Kiyosaki	June
Unit 7	2 bedroom	900	\$900	\$900	Hopkins	February
Unit 8	2 bedroom	900	\$900	\$900	Stullick	June
Unit 9	2 bedroom	900	\$900	\$900	Beckel	April
Unit 10	2 bedroom	900	\$900	\$900	Struve	June
Unit 11	3 bedroom	1050	\$1000	\$1000	Thorn	July
Unit 12	3 bedroom	1050	\$1000	\$975	Sobotka	May
Total			\$10,000	\$9,500		

Let’s say, using simple numbers, your monthly gross potential rent income is \$10,000, and your monthly actual potential rent income is \$9,500. Using our example from above, we have three units with leases expiring in May of your budget year that are below market and four more expiring in June. In the rent roll listed, you have \$500 per month in loss to lease or \$6,000 annually. In other words, you have \$6,000 in rent growth, right in your own rent roll. However, you also have significant *exposure* with over 50 percent of your property with seven expiring leases in two consecutive months (May and June). A word of caution, however, don’t be too aggressive in raising rents on residents who wish to renew their lease if they are severely below market. You could end up creating vacancies.

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
1	1	0	1	3	4	1	0	1	0	0	0

CONCESSIONS

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$(34,706)	63.32%	\$(21,250)

Anytime you see a banner posted or an ad that claims “One month free,” you are looking at a concession in the rental market. It is important to stay on top of concessions in your market, and the best way to do this is through your market survey. If you do not have your finger on the pulse of the market and know what, if any, concessions are being offered, you will lose a lot of money. Why would anyone rent from you for \$900 per month with no concessions, when they can rent down the street for \$900 per month with a month free? On a twelve-month lease, that is \$75 per month in savings—for them, and a \$900 loss for you. Wouldn’t you rather it was the other way around?

Budgeting for concessions is not a science. In fact, it is simply a projection. There is no way to know for certain which direction the market is going to turn when it comes to concessions. It fluctuates due to supply and demand of housing inventory, population, and employment. You want to budget realistically. It is always better to beat a budgetary expectation than to bust your budget because you were being unrealistic. If your market survey tells you that your market is currently waiving security deposits and giving a month free on a twelve-month lease, then budget for that. It is always better to be safe than sorry.

Let’s take a look at our previous year’s actual to get an idea of what kind of dollar amount we might want to use for our new budget regarding concessions. First thing you’ll notice is that there is a fairly significant increase in concessions of 63 percent reflected in our financial from the previous year to the current year. We should definitely check our market survey to make sure that we are not the only ones giving all this money away. If we are giving concessions away above market, we should stop immediately. We’ve already established that our rents are at market, so there is no reason to give concessions as an enticement.

Let’s assume, however, that we are in tune with the market regarding concessions. One thing you should note is that even though we increased the

amount we give away in concessions in the current year from \$21,250 to \$34,706, we also increased our market rents. Our gains in rents more than outweigh the concessions that we offered. Additionally, the loss to lease numbers were significantly lower in the current year than in the previous year, so we can safely assume we were not trying to artificially push the market rent when it came to gross potential rent income. The old adage is true. Sometimes it takes money to make money. It definitely appears so in this case.

Again, in making our new budget we should consult the market data we received from our broker. Doing so, we see that home prices and interest rates are on the rise, and are expected to remain so, forcing many people to rent since they cannot afford to buy a home. We already know that the rents are expected to rise 4 percent. So, we can safely assume that given the fact that more people will be in the rental pool due to rising housing prices, and that rents are expected to rise, concessions should fall. Actual concessions for the current year were 1.9 percent of the total gross potential rent income. Let's conservatively lower that to 1.5 percent, or \$27,375.

OTHER LOSS

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$(46,033)	-11.02%	\$(51,731)

There are a number of things that would go into the other loss category. These generally include money that was supposed to be paid to you, but that the resident has held out on. For instance, if a resident moves and owes you rent or has damaged an apartment to the extent that the damage deposit won't cover the costs, you would contact the resident and charge them for the work. Unfortunately, many times residents are either hard to track down, or unwilling to pay these amounts. This might be a good time to point out that you should always get a resident's new contact information when they move.

Any amount that is owed to you but not paid is considered bad debt. Oftentimes you will send these debts to a collection agency and they will try to recover the bad debt for you. Sometimes they will succeed, other times they won't. Money that is collected is referred to as bad debt recovery, and money that is not collected is considered bad debt write-off (since you will be able to write this off as a business loss).

Bad debt will vary from property to property depending on management, location, market, and demographics. The best way to budget for bad debt is to look at your property’s history and budget based on the average trend. In our example you can see that bad debt was decreased significantly from the previous year to the current year. There are a couple of reasons why this might happen. Maybe it was simply a good year for the property. Another reason might be that the management tightened its screening and attracted higher quality renters and there will be significant documentation on all of this. In this category, it is always better to have more than just two years comparison, but for our sake we will assume that the rental profile is getting better and budget for \$47,000 in other loss.

If you are purchasing a property with a rough management history then you can be sure that there will be a “hangover” period or higher loss while you adjust your residents’ behaviors.

VACANCY

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$(158,758)	20.40%	\$(131,863)

There are two types of vacancy that you should keep an eye on. One is your physical vacancy, and the other is your economic vacancy. Both are easy to calculate. Physical vacancy is the amount of money lost from having a unit vacant divided by the gross potential rent income, after loss to lease.

$$\text{Physical Vacancy} = \text{Vacancy Losses} / \text{Gross Potential Rent Income}$$

In the case of our example above, the physical vacancy for the current year-end financials was 9.05 percent. We determine this number by dividing our vacancy losses of \$158,758 by our gross potential income of \$1,754,800.

For budgetary purposes, we will focus only on physical vacancy, but later in this section I will show you the importance of tracking your economic vacancy as well. In looking at our year-to-year financial comparison above, you should immediately notice that in raw dollars vacancy for the current year was a whopping 20.40 percent higher than the previous year! At first, this may send a shock to your system. You should never pay attention to that percentage. Here’s

why. We raised the gross potential rent income so the vacancy will be higher in dollar amounts even if it remained constant physically.

You always want to compare the physical percentage when comparing financial years. In the case of our example, we had 7.9 percent vacancy in the previous year and 9.04 percent vacancy in the current year. Again, we determine this by taking the vacancy losses and dividing them by the net gross potential rent income. So, for the current year we did experience almost a 1.2 percent increase in vacancy than in the previous year. Thankfully we raised the rents 4.5 percent. The increase in rents more than makes up for the losses in vacancy, and we also feel confident that vacancy and concessions are going to be even lower in the coming year thanks to our market data. That means more money in our pockets and higher value for the property. With this in mind we will budget for the coming year's vacancy numbers of 8 percent. It's shaping up to be a good year.

Economic vacancy is all your rent income after all associated rental losses (effective rent income) divided by your net gross potential rent income. It accounts for your actual cash versus what you could have collected.

$$\text{Economic Vacancy} = \text{Effective Rental Income} / (\text{Gross Potential Rent Income} - \text{Loss to Lease})$$

Effective rent income is the amount of money you truly collected versus the amount you could have theoretically collected. It accounts for all rental losses such as concessions, vacancy, bad debt. In the case of our example our effective rental income is \$1,434,696 for the current year financial. To figure our economic vacancy we will take that number and divide it by our gross potential rent of \$1,754,800 minus loss to lease. We now see that our economic vacancy for the current year-end financials is 19.29 percent.

Do you see why it is important to keep track of your economic vacancy? In this example it is almost double the physical vacancy. We only collected 80.71 percent of the potential rent income for the property. While economic vacancy will always be higher than physical vacancy, you generally do not want it to be this high, so we will need to do some sleuthing to figure out whether we might have been too aggressive in raising our rents.

There are a couple of things to keep in mind when we analyze this. We know that our expert's market data projects rents will continue to rise and vacancy will continue to fall. That is a really good sign right there that we are on the right

track and that our economic vacancy losses will shrink in the coming year. The other is that we budgeted for fewer concessions in the new budget. Given these two factors, we should feel pretty confident that raising rents in our new budget is the right thing to do and that higher occupancy and fewer concessions will net us an acceptable economic vacancy. Finally, we will compare our previous year's economic vacancy to the current year and see if we are trending identically. In the previous year our economic vacancy was 22.72 percent and our current year economic vacancy is 19.29 percent.

OTHER INCOME

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$109,869	64.10%	\$ 66,953

Some of the biggest missed opportunities for generating income in investment property are fees. Earlier in this section we talked about the power of finding missed income opportunities and instituting them on your property. Remember how much income was produced by something as simple as implementing RUBS? The value of the property was increased by \$1.7 million. Well, RUBS isn't the only thing you can implement to increase your other income. Here are some common things we charge fees for on my properties. If you are not charging fees in these areas you are missing out on some huge income potential. The ranges will vary based on market conditions and management philosophy.

- Rental applications—paid by applicant, for opportunity to move in—\$25 to \$100 each
- Administrative fees—for processing leases—\$100 to \$500 per move-in
- Nonrefundable deposits for pets—for potential pet damage—\$ 100 to \$1,000
- Monthly pet rent—pet owners will pay more rent—\$10 to \$50
- Billing residents back for damages—pets, children, general—varies based upon incident

- Laundry income—owner-provided laundry machines—\$1 to \$2 per load per machine
- Late fees—pay after due date in lease—\$25 to \$100 plus \$5 to \$15 per day
- Nonsufficient funds fees—bounced checks cost you—\$25 to \$50 (don't forget to *also* get late fees!)
- Parking/carports/garages—\$25 to \$200 depending on type of parking and supply/demand in area
- Corporate rent income—short-term furnished—\$500 to \$ 1,000 extra per month—depends on term
- Month-to-month fees—for residents that do not renew lease for extended periods—\$50 to \$200 per month extra
- Buyout fee—relocations or lease breaks—one month's rent

For your property there may be others. Each property will have unique opportunities to generate other income. When creating a new budget, each one should have its own line item.

In determining our new other income budgetary number we will have to first determine if there are any other areas where we might be able to generate other income that we have not taken advantage of. For the sake of our property, let's assume that we are collecting in every area for other income that is possible. This will not always be the case as we saw with the institution of RUBS.

Second, we need to check our market survey. Are the property's fees in line with the market? If most properties are charging \$50 for a rental application and we are charging \$25, it makes sense to raise that fee to \$50. Little additions like that add up big in the end.

Third, as you will see when we cover expenses, we will have researched the coming year's utilities. If there is going to be an increase in utility costs, then we will have to adjust our expected RUBS income for the new budget accordingly.

Operating Expenses

Operational expenses are much more controllable than income. For this reason, you should pay close attention to your budget throughout the year to make sure you are within your budgetary expectations. If you are not, you should take a

close look at why.

In my company we generate monthly variance reports that the managers use to explain any positive or negative variances in budgetary categories. Sometimes the variances are unavoidable. A change in market conditions that is not foreseen, like the spike in insurance rates after Hurricane Katrina or an unexpected plumbing repair, can bust your budget. While the goal is to try to stay within your budget, it would do you good to remember that the budget is supposed to be an accurate reflection of the property's financial needs to operate at its peak performance. If you know that you will need to bust a budget category for your property to operate smoothly then do so and adjust accordingly in the next year's budget.

The next chart is a sample of a property's annual operating expenses and how they compare to the previous year. Now let's go through each category:

	<i>Current Year</i>		<i>Previous Year</i>
	<i>Amount</i>	<i>% Change from Prior year</i>	<i>Amount</i>
ANNUAL OPERATING EXPENSES			
Professional Management	\$46,337	2.91%	\$47,727
On-site Management/Payroll	\$169,708	-8.62%	\$156,244
Administrative	\$39,704	-3.79%	\$38,254
Advertising	\$23,968	-6.63%	\$22,478
Tax and Insurance	\$161,419	-11.34%	\$144,976
Utilities	\$64,223	-13.17%	\$56,751
Repairs and Maintenance	\$72,769	-19.57%	\$60,860
TOTAL OPERATING EXPENSES	\$578,128	-9.64%	\$527,289
PROFESSIONAL MANAGEMENT			
	<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
	\$46,337	2.91%	\$47,727

If you are using a professional management company you will have to budget a fee that is paid to them. Depending on the size of the property, these

fees will vary. This is something we'll get into in more detail later in the book. For now, we'll stay within the context of our example.

The management fee should be a percentage of the total income collected for the property. Never sign a management agreement that is a flat fee only. I always feel that if the property management company's income is based on income performance that they will put in much more effort.

This is probably the easiest category to budget for. Chances are that if you are using property management, you already have a contract in place with a constant percentage. In the case of our property here, it is 3 percent of the gross income in the current year. We will use 3 percent for our new budget.

PAYROLL

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$169,708	-8.62%	\$156,244

For larger properties, payroll covers all the costs associated with staffing your property. These would include your manager, leasing, maintenance, and housekeeping salaries, as they apply. This also covers bonuses, and other costs such as 401(k) plans, state and federal taxes, worker's compensation, and health and dental insurance. Payroll is not a category to skimp on, by the way. Quality people need to be compensated fairly. Otherwise, your property will suffer. You know the old saying: "You get what you pay for."

For each market, pay scales will differ. If you are not familiar with your market, that is all the more reason to, at the very least, consult a local professional property management company. They know the average salaries that are expected by your employees. They will also be able to assess your property and determine how much maintenance and management it will need. For instance, if your property is running at 95% occupancy and is in a strong market you may not need to pay for extra leasing agents. Additionally, it is helpful to audit your maintenance requests. Are there enough to justify having a maintenance supervisor and a maintenance technician, or do you only need one maintenance person?

As I said, the goal is not to slash costs, it is to determine what will be needed to have your property functioning at its best. Each year you will have to give raises. Make sure to budget for this. Even if you don't make any changes in

regards to your staff, you should budget for increases in payroll costs.

For our property, the staff will be remaining the same in our new budget. We will factor in a percentage increase to account for pay raises. We'll budget a 3 percent increase.

ADMINISTRATIVE

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$39,704	-3.79%	\$38,254

Administrative costs refer to both the professional fees that you will have to pay to attorneys and accountants for normal business operations, as well as expenses that are generated in order to operate the property on a daily basis. These would include such offsetting costs as office supplies (paper, pens, and so on) and credit and criminal checks. These costs will generally remain fairly constant, so for our new budget we will stay with our current-year costs of about \$40,000.

ADVERTISING

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$23,968	-6.63%	\$22,478

Advertising costs are any expenses associated with marketing your property to the general public to generate traffic for future rentals. If you have a single-family house this might be as little as a classified ad you need to place in order to attract a renter, a fee charged by a locator, or a commission a Realtor would charge. The larger the property, the more it will cost to advertise it. Generally, on a large property you will have multiple sources of advertising ranging from Web sites to print magazine ads in local apartment magazines like *Apartment Guide*. In addition, you may use locator and referral services that will charge fees. You should also include any costs associated with resident retention programs such as move-in gifts and management-sponsored resident parties. Good managers spend time and effort retaining the existing residents. A low cost

with a potentially large gain.

Once again, we should look at some historical data in helping to determine our new advertising budget. For starters, if you are not keeping track of where your traffic is coming from, you should begin now. If you are paying \$250 per month for a spot on a Web site and nobody mentions that they used it to find your property, you might want to consider where that money could be better allocated. Tracking your traffic is easy. You should have a form that you or your staff fills out whenever someone calls on the phone or walks through the door. On this form you should take all pertinent information such as name, address, phone number, and what the potential resident is looking for regarding a rental and what price range they are looking to stay in. You should also have a line item for each traffic source used to find the property, from a simple drive-by to a magazine advertisement.

Once you have reviewed your traffic and determined what advertising sources have best served your property, you should also look at the occupancy of your property. If you are 97 percent leased and have a waiting list for certain floor plans, there is no reason you would need to be on two Web sites and have advertising in four different print sources. You would be able to easily cut back and save money. You should also consider raising the rents on the floor plans that have a waiting list.

For our property, we are not where we want to be when it comes to occupancy, so there is no apparent reason to reduce our sources of advertising. We will, however, make sure that we are maximizing the potential of our advertising dollar by reviewing the traffic. Say, upon review, we discover that an ad we placed in a local magazine has produced very little traffic, yet is costing us \$1,200 per month. Let's cut that advertisement and reallocate the money into a more effective advertising source. This could be anything from a different publication to resident functions like wine and cheese socials.

Now that we have determined what we want to keep and what we want to cancel, we need to get estimates of the costs. This is done by calling the account representatives for each advertising source and asking for an estimate for the coming year. Let's suppose that by doing this, we discover that a couple rates have gone up slightly in the coming year and that our advertising costs will be about \$1,500 more.

Remember, these are not set in stone. If during the course of the year you feel you can decrease advertising spending, then by all means do so. You are not bound to stick to the budget. Conversely, if you feel that you need to increase

spending, perhaps by utilizing a referral source, then you should do so. Above all, continually analyze your traffic sources throughout the year and keep on top of the effectiveness of your marketing dollars.

TAXES AND INSURANCE

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$161,419	-11.34%	\$144,976

Like they say, there are two sure things in life, death and taxes. In property management I would include insurance. You cannot acquire an investment property without insurance. The lender won't let you. Since they are the ones that actually own the asset if you have a loan, they understandably want it insured. Taxes and insurance are expensive and one of the few costs you have very little control over. They just simply have to be paid.

Determining your budget figure for these categories is simple. For taxes, call the tax assessor's office and ask what the taxes will be for the coming year or use your accountant to determine this for you. You can also find this information on most county assessor Web sites by using your tax or parcel number.

For insurance, call your insurance broker and get competing bids or the figure for your renewal on the existing insurance policy. There are only a few things you can do to impact the amount you will have to pay for insurance. One I've already mentioned, which is obtain competing bids. Maybe another insurance company will be able to supply the same coverage at a lower price. You never know unless you check. Another option is to vary your deductibles and/or limits. Generally, you'll want to have coverage for the big things and not worry about coverage for things that can easily be taken care of out of pocket. While having large deductibles can be beneficial on a monthly premium base, they carry obvious drawbacks. If something were to go wrong, you are looking at a substantial expense. It is always wise to consult with your insurance broker on the drawbacks of each policy decision.

UTILITIES

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$64,223	-13.17%	\$56,751

Utilities vary from property to property, state to state, and city to city. Utilities are made up of the following: electric, gas, trash, sewer, water, cable, and phone. Generally, they will always rise in cost. As I mentioned before, it is always advisable to push as much utility cost onto the residents as the market will allow, as they are the ones that use them. Inevitably there will be utility costs associated with operating a property that will be your responsibility. These include all utilities required to operate the clubhouse area, common areas such as pools and parking lot lighting, and utilities on vacant units.

The best way to prepare your budget is to contact each company for all your utility accounts and get an estimate of the rates for the coming year. Determine your figure based on the rates that they quote to you. It is best to annualize these costs. That means dividing the total budgeted cost across the twelve months of the year evenly. Since many utility costs are seasonal, you will probably have higher than budgeted costs and lower than budgeted costs at various times throughout the year. For instance, if you operate properties in Phoenix and you heat the pool with gas, your gas expenses will be higher in the winter, but nearly nonexistent in the summer.

Keep a close watch on your utility costs during the year. If you see extremely high costs above budget, you should refer to your variance reports and see if there is a reasonable explanation. If there is not, you should do some investigating. Remember our 200-unit property? The owners were overbilled by the city for sewer utilities for over seven and a half years. Never rely on the companies that supply your utilities to make corrections or question what they charge you for. Rather, trust but verify. If the utility company is charging you fairly, you need to take a look at how you are using your utilities. Did you forget to stop heating the pool once the summer rolled around? Maybe your employees aren't turning the lights off in the clubhouse during the hours it is closed. Do whatever you can to eliminate utility waste. All of these things add up quickly and impact the value of your property by reducing your net operating income. On my properties, we installed timers in bath and laundry rooms to help reduce utility waste.

REPAIRS AND MAINTENANCE

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$72,769	-19.57%	\$60,860

Rich Dad Tip

Good property management companies have pre-negotiated contracts with set pricing for their approved vendors.

These costs will vary depending on the age of your property, the speed and efficiency with which you or your property management company reacts to maintenance requests, and the quality of your resident profile. There is no surefire way to budget for maintenance costs other than by looking at the historical trends for your property. Costs that would fall under this category include but are not limited to:

- Carpet cleaning
- Interior painting
- Electrical repairs
- Heating and air-conditioning service
- Plumbing repairs
- Appliance repairs
- Landscaping
- Pool service
- Pest control

What doesn't fall under this category are replacement costs for appliances and major projects to upgrade a property. Those are considered capital costs, and

we will address those in the next section.

Repair and maintenance costs will generally rise each year as parts become more expensive and the cost of hiring third-party companies rises. If you are taking over a property that has a lot of deferred maintenance issues, or a property that is brand-new, then you will have to factor in some deferred costs for each. Such is the case for our property example here. That property in our budgetary example was brand-new when we purchased it, and because the one-year warranty was expiring, we budgeted a significant increase in costs associated with repairs and maintenance. Generally, however, you should budget about a 2 percent increase each year for repairs and maintenance. So that is what we'll do for our new budget.

NET OPERATING INCOME

<i>Current Year</i>	<i>Change</i>	<i>Previous Year</i>
\$966,437	15.46%	\$837,028

Net operating income is determined by subtracting your total operating expense from your total operating income. As I've mentioned, net operating income will determine the value of your property. It is your property's report card.

	<i>Projected</i>	
	<i>Amount</i>	<i>% Change from Current Year</i>
REVENUE		
Gross Potential Rent Income	\$1,824,992	4%
Gain/Loss to Old Lease	-118,624	47%
Concessions	-27,375	21%
Other Loss	-47,000	-2%
Vacancy	-145,999	13%
Effective Rental Income	1,485,993	4%
Other Income	112,066	2%
TOTAL INCOME	\$1,598,060	4%
ANNUAL OPERATING EXPENSES		
Professional Management	\$47,942	-3%
On-site Management/Payroll	174,799	-3%
Administrative	40,498	-2%
Advertising	25,468	-6%
Tax and Insurance	166,262	-3%
Utilities	66,150	-3%
Repairs and Maintenance	74,225	-2%
TOTAL OPERATING EXPENSES	\$595,344	-3%
Net Operating Income	\$1,002,716	5%

CAPITAL EXPENSES

	<i>Amount</i>	<i>% Change from prior year</i>	<i>Amount</i>
Capital Expenses	\$44,694	-162.89%	\$17,001
Income Before Debt	\$921,744	-12.40%	\$820,027
Debt Service	\$684,258	0.00%	\$684,258
Cash Flow	\$237,486	74.92%	\$135,769

There are other expenses associated with the property that do not necessarily affect the value of the property from an operational standpoint. These would include capital expenses and debt service. The reason for this is that capital expenses generally add physical value to a property and debt service is

determined by factors outside the operations of the property such as the credit-worthiness of the purchaser and interest rates.

Every property will eventually need some major projects completed to keep it up to date, or in some cases simply to make it livable. These are major projects such as replacing roofs, repaving parking lots, and changing out appliances. If you are building a budget for a property you are acquiring or taking over management of, make sure to thoroughly investigate the capital improvement needs. A new roof a year after takeover must be budgeted or you're going to be in for a nasty surprise.

Capital expenses will generally remain constant, unless you are planning some major renovations or some special projects for the coming year. It is a good idea to set aside a separate account called a capital reserve account in order to cover these expenses. Generally, a capital reserve account should be equivalent to one month's mortgage payment. As you draw from this account, you should also replenish it throughout the year so that it is always there in case of an emergency. It's difficult to fund large capital projects out of operating income and retain positive cash flow. Conversely, if you have extra funds in your capital reserve account you can always refund your property a proportion of the overflow.

Rich Dad Tip

Always keep a capital reserve in order to complete large, one-time capital projects.

A word of caution: Never put off capital projects that need to be done. You may think you are saving money, but you really aren't in the long run. During the due diligence phase, anyone who is looking to purchase your property will sniff out deferred capital projects and use those against you to drive the price down much lower than the actual cost of completing those projects. In the end,

your “savings” will actually be a loss.

CASHFLOW

The whole idea behind this crazy business is to generate cash flow on your investment. The Rich Dad education is based on this concept. Cash flow is what can be distributed in actual dollars after all the bills are paid; this is what we buy real estate for, so we can generate enough cash flow to become financially free!

When I’m looking at purchasing a building I never pay attention to the price at which a building is listed. Instead, I focus on the net operating income and my ability to increase it over time.

I can’t stress enough how important it is that you maximize your income and minimize your expenses in order to have the highest net operating income possible. Let’s take a look at the new budget we have been building throughout this section and see how much we’ve increased our net operating income. This will also help us determine how much we have increased the value of our investment.

As you can see, our projected net operating income of \$1,002,716 is 5 percent higher than in the current year, which was \$966,437. That equates to \$36,279 in extra income for the coming year. If we are able to achieve these very manageable increases we will have increased the property’s value by over \$600,000 in a year based on our original 6 percent capitalization rate.

Rich Dad Tip

Never forget your property’s value is based on its net operating income.

Chapter Four

A Month in the Life of an Owner-Manager

In the last chapter we explored the financial aspect of property management. In this chapter we will explore the operational aspect of property management. Very often I find people have no real concept of the amount of work and energy that goes into managing property effectively on a daily basis. In this chapter we'll put you in the shoes of an owner-manager and take you through his or her typical daily routines over the course of a month.

Imagine that you own an eight-unit apartment building with an average rent of \$900 per unit, and have decided to take on the management of the building yourself. If you are anything like most of the people I meet at Rich Dad seminars, your real estate investments are a supplement to your full-time job, and a sound plan for retirement. That means most of the property's management will be done in your off-hours, or you will have to take time off from work to focus on your property. What we'll do now is run through the various tasks and difficulties that you would face throughout a month. Once we have done that we will list them out along with the time commitments generally required to complete them. This will paint a clear picture of the time and energy needed to successfully manage your investment.

Just as you did when we reviewed property management systems, you should make your own list of what you think would typically occur in the course of the month were you to manage this eight-unit building. Also, assign how much time you think each task will take. When we are done with this chapter, I think once again you will see a significant difference between my list and yours.

At the beginning of each month, you will have to collect the rent. In your

eight-unit building we'll assume there are seven occupied units and one vacant. That means you are 87.5 percent occupied. That is probably the percentage occupancy that you need either to have a small amount of cash flow or break even. So, right off, you have the pressure of knowing that you need to collect on all the rent, or you will have to dip into your own money or the building's reserve account to continue operating.

Generally, the collection of rent occurs from the first to the third of the month. It is a good idea to set a specific date on which the rent is late, and to start charging late fees if the rent is not turned in by that date. Strict enforcement of late fees is essential. If you let people slide, word will get out. Even worse, if you let one person slide and not another, you may be at risk to be sued because you are being discriminatory. Fair housing laws are very strict and require you to treat every situation the same no matter who the person is.

Residents are unbelievably creative when it comes to excuses for why they can't pay their rent on time. I asked my managers to e-mail me some of the best excuses that they had heard from their residents. The list was pretty standard:

- "I don't get paid till Monday [or Tuesday, or Wednesday, or whatever day is convenient]."

- Any sort of family emergency.
- "My roommate won't give me their half of the rent."
- "I was working every time your office was open."
- "I didn't know there was a drop box."

The one that takes the cake, though, belongs to the manager on a property that I own in Sun City, Arizona. She had a resident tell her that they couldn't pay their rent because they had just got an "awesome" deal on some cocaine. They assured her that once they were able to move it, they would be back to pay the rent. What is most interesting about this story is that this is a 55-plus age-restricted property!

The point is that people will say anything to wiggle out of having to pay rent. Usually, they will try to make you feel guilty for expecting them to live up to their contractual obligations. That is why it is essential to be able to refer back to a documented lease and community policy that is signed by both the resident and you.

For example, let's say that two of your seven residents have paid their rent. One check arrived on the first and another one on the third. You quickly took

those two checks to the bank on your lunch hour. On the fifth day, you had not received any rent from your other five residents, so you had to go to your building after work. Thankfully, everyone is home. Four of the remaining residents write you checks on the spot, saying they apologize but they forgot to mail in their checks. One of the residents, however, tells you she can't pay until her next payday, which is in three days.

You inform the resident that is fine, but she will have to pay late fees for those two days. The resident pleads with you, saying she hasn't paid late before. "Can't you just let it slide this time?" You tell her that it is unfortunate, but refer back to the lease that she signed, which details exactly when rent is late, and the structure for late fees. She swears at you and slams the door.

Now, assess the situation. You have a total of eight units, seven of which are occupied by residents. Six have paid their rent on time, one is delinquent, and one unit has been vacant since the resident moved out less than a month ago.

In the meantime, while you were collecting rent, three of your residents asked you to take care of some maintenance issues in their units. You need to have a water heater fixed, a toilet unclogged, and a leak under a kitchen sink repaired. You tell the residents that you will call them to schedule a time to stop by and address those issues. You make a note to call them tomorrow on your lunch break.

You get ahold of two of them and schedule to stop by on the following Saturday since you will be going over there to start work on making the vacant unit rent-ready anyway. You call the other resident when you get home from work and he says the weekend won't work for him, and he would like you to fix the leak now. The idea of hiring a plumber for a minor leak kills you, so you go over to the unit before dinner and fix it yourself.

On Saturday, you rise early from bed so you can start work on the two remaining maintenance requests and the vacant unit. You also want to see if your delinquent resident is ready to pay you the rent she owes, along with the late fees. You have tickets for a sporting event later that evening, and want to be able to get a lot of work accomplished before then.

First thing you do when you get to the property is knock on the door of the resident who still owes you rent. She answers in her bathrobe and hands you a check for the original rent amount. You remind her that she owes you some late fees, and she tells you she can only afford to pay the rent amount. You tell her that you will not accept partial payment, and hand back the check. She informs you again that she cannot pay the late fees. You tell her that she needs to or that

you will have to serve her an eviction notice. Cursing at you again, she slams the door in your face. You write a note to call your lawyer to start legal proceedings against the resident.

Next you take care of the two pending work orders, fixing the broken heater and unclogging the toilet. Finally, you are ready to start work on the unit that has been vacant for ten days. Remember, every day the unit is vacant is lost income. If this particular unit rents for \$900 per month, that is \$30 per day in lost income. So at this point you have already lost \$300 in potential rent.

Once you enter the unit the first thing you do is assess the situation. What work needs to be completed? Upon a close inspection you find that the unit requires a little more work than your initial estimate. It needs general maintenance such as replacing some light bulbs, new paint throughout, a pretty deep cleaning, and the carpet needs to be cleaned and possibly replaced. You write all these down and compare the list to the move-in sheet. Next, you need to determine what the previous resident will be responsible for and apply those charges to the security deposit.

There is only one problem (which is a lot more common than you might expect): when the previous resident paid their last month's rent, they gave you the rental amount minus the security deposit. So now you have a vacant unit that is costing you \$30 per day, and no operational funds to cover the work that is needed to make the unit rent-ready.

Because you have no choice but to start getting the unit ready, you move forward. The biggest question you'll face is whether to do the work yourself or hire someone to do it for you. There are a couple of things to consider when evaluating this. How much is your time worth, and do you have solid industry contacts to get the work done cheaply? The concept of time versus money is something that we'll look into in more depth later in this chapter. For now, let's assume you have decided to complete the general minor maintenance issues and paint the unit yourself. You will hire professionals to clean the carpet, a better decision than renting a carpet-cleaning machine from your local store.

You are now faced with a dilemma. Do you forget about your plans and try to finish the painting, maintenance, and cleaning work over the entire weekend, or do you go to the sporting event and try to finish all the work on Sunday alone? Otherwise you will have to take time off from work to finish, hire someone, or wait until next weekend. All of which will cost you money!

Knowing that there is a lot of work ahead, you grudgingly call your friends and tell them that you won't be able to go with them to the sporting event

tonight, and head off to the hardware store to get the supplies you will need to start the work. You purchase \$150 in paint supplies and \$50 for some fixtures that need replacing.

On the way to the hardware store you call a carpet cleaning service that you use frequently to set up an appointment for them to do work on the unit. The carpet cleaners can't make it till Wednesday afternoon. You grimace a little because that means you won't even be able to start showing the unit until Thursday, which will cost you another \$120 in lost rent. Beyond that, you will have to take time from work to meet the carpet cleaners to let them into the unit and then again later to inspect their work before payment. Just more time and money lost.

Once you have the apartment turned, a process that takes about a week, you now have to begin leasing the unit. As I mentioned before, with just one unit vacant you are at your cash flow break-even point. You are feeling the pressure of having lost income each day the unit is vacant.

Additionally, it is now the 15th of the month and your resident who is delinquent on their rent still has not paid. You have to start eviction proceedings. That will take time, depending on your local laws. If you do end up evicting the resident, and still have not rented the vacant unit, you will then have two vacant units and be only 75 percent occupied. This will just be more maintenance costs and more money for advertising. At that point you will be experiencing some pretty hefty negative cash flow. You decide to increase your budgeted line item for TUMS.

In order to lease the vacant unit you place an advertisement that costs \$100 per week in the local paper, and put up a sign that says "Now Leasing." A few people are calling about the apartment on your cell phone while you are at work. You make appointments to show the unit in the evenings and on weekends; hopefully they will show up and are on time; they probably are looking at several options and so may not come at all.

In the midst of all this, you still have to deal with the standard operations of the property itself. You meet with the landscaper to make sure the work is being done correctly. It is always advisable to personally inspect the work that your subcontractors are doing.

Rich Dad Tip

A subcontractor that is unmanaged will do an unmanaged job.

The bills for the property will have to be paid as well. Since you have collected rent on six units that will be your income to pay the month's expenses. Let's stick with our average rent of \$900 per month. That means for this month you will have collected \$5,400 for the month in rent income. If you are applying the principles in this book, you are probably collecting some other income through fees and utility bill-back as well. Let's say that is another \$500. So you have a total of \$5,900 to pay the month's expenses. Here is a general breakdown

<i>Item</i>	<i>Cost</i>
Apartment Turn	\$300
Advertising	\$200
Legal Costs	\$200
Insurance	\$500
Tax Impounds	\$400
Utilities	\$800
Maintenance for Pool	\$100
Pest Control	\$150
Mortgage	\$3,500
<u>Vacant Utilities</u>	<u>\$150</u>

of your expenses for the month: **Total** **\$6,300**

Keep in mind that these are simply hard costs. They don't take into account the cost of your time including driving to and from the property and the hardware store. Let's take a look at the work that you had to do throughout the month and assign a monetary value to that time. For neutrality sake we'll use the U.S. Census Bureau's number for the average U.S. salary, which is \$45,790. That is \$22.01 per hour.

<i>Item</i>	<i>Hours</i>	<i>Cost</i>
Collection of rent	3	\$67
Work orders	3	\$67
Eviction	1	\$22
Turning the vacant unit	12	\$267
Paying the bills	3	\$67
Showing vacant units	4	\$89
Resident communication	1	\$22
Inspecting hired work	1	\$22
Total	28	\$623

These figures don't take into account the lost value of things you missed out on in order to take care of your property. I'm talking about things that don't have a monetary value, such as missing the sporting event with your friends, or not being able to see your favorite television show, or spending time with your family. But at least you were saving money, right? Not really.

We'll assume that on average, the fee to have an eight-unit building professionally managed in your market is around 8 percent of the total income collected. That comes out to a total of \$640. Your time value based on just the U.S. average is \$623 for the month. So basically the total monetary savings to you for managing the property yourself is \$17. You probably spent that on aspirin. I'm not telling you that you shouldn't manage your own property, but the numbers don't lie. A majority of the time, there is very little monetary advantage in managing your own property. You better enjoy doing all this work because that's the only value you've created.

Professional Management Fees: What They Do for You

I'm approached by people at Rich Dad seminars who continually have one question, "How much should I expect to pay for professional property management?" My answer is always the same: I don't know. The first thing you need to understand about management fees is they vary just like anything else you purchase. Management fee percentages will be influenced by average market rents, demand, location, and size.

To show you what I mean, let's look at two hypothetical buildings with ten units each. One is in New York City and the other in Oklahoma City. For the New York City building the average rents are \$2,000 per month for each unit. In Oklahoma City they are \$400. Both buildings are 90 percent occupied. Now,

let's see how the numbers compare on an 8 percent management fee:

<i>City</i>	<i>Total Rent</i>	<i>Total Collections</i>	<i>Management Fee</i>
New York City	\$20,000	\$18,000	\$1,440
Oklahoma City	\$4,000	\$3,600	\$288

For the same size building, a property manager in Oklahoma City would collect \$1,152 less per month in management fees than in New York City even though the workload is probably close to the same. If there were a standard for fees that property managers charged, I think there would probably be a shortage of property managers in Oklahoma City. It wouldn't be financially feasible. The best way to find out what the going market rate for management fees in your market is to talk to a number of local management companies.

Because they all have to compete with each other, you will find that they rarely artificially inflate their fees.

A common misconception is that the management fee covers the property's expenses. That is not the case. Any and all costs associated with the property are the responsibility of the owner. These include: • Payroll for on-site employees (if any)

- Administrative costs
- Advertising
- Taxes and insurance
- Utilities
- Repairs and maintenance
- Capital costs
- Debt service

The management fee simply covers the cost to coordinate services and to manage the property to its peak performance. I have a sample agreement on my Web site, KenMcElroy.com. Make sure all management company responsibilities are clearly spelled out in the management agreement before you sign it. Here is a chart detailing what typically would be the responsibility of the management company and what would be the responsibility of the property owner: Property Manager Responsibilities

All resident communications

Collect rent

Tax appeals

- Market and lease apartments
- Coordinate all maintenance
- Budgets
- Set up and maintain all vendor accounts
- Perform market surveys and analysis
- Raise rents and fees according to market standards
- Coordinate and oversee all capital projects
- Oversee all resident legal issues
- Produce monthly and annual financial statements
- Coordinate payment of all bills, including debt service

Owner Responsibilities

- Review financial reports generated by the management company
- Provide funds as they are needed outside of operating accounts

It's important to remember that all investments have associated costs. Many times you are not aware that you are paying those fees because they are layered into the investment itself. Such is the case when using financial advisors or stockbrokers. Real estate is a business, not just an investment. One of the things I appreciate about real estate is that the fees are not hidden. If you hire a property manager, you know exactly the rate at which you will be charged for their services. That is not the case with many other investments.

Rich Dad Tip

Anybody managing anything will cost either time or money.

Time-Poor

In my company I deal with a lot of investors who I like to call “time-poor.” Time-poor people are professionals who have money to invest, but do not have the time that it takes to find and manage quality investment properties. This is

not a position you want to be in, so it's important you assess the extent to which you are able to devote time and energy to managing your property or properties.

Chances are you work full-time. If you are married, chances are your spouse does too. Assuming you get eight hours of sleep a night, you have roughly 112 hours per week to get all the things you need to get accomplished in a week. Now, take a moment to write down how you generally spend your time during any given week.

You probably spend around 40-50 hours a week at work, right? Now, factor in your commute time. The U.S. average is 24 minutes a day, which equates to 2 hours per week. So far you are looking at 42-52 hours per week. That leaves you with 70-80 hours to get all the other things done in your life. I don't know about you, but I find that I never seem to have enough time to get done the things I need to get done. Here is just a fraction of the tasks that need to be done in any given week:

- Grocery shopping
- Paying the bills/budgeting
- Cooking meals
- Cleaning the house
- Yard work/maintenance
- Spending time with family
- Watching my favorite TV show
- Reading a good book

Notice that the list above consists of work and play. Both these things are vitally important to your health and balance in life.

My point is this, once you add up all the things that take up time during your week, you probably will find that you too are time-poor. If you are too busy to do the things that you already need to, you probably shouldn't be taking on managing your investment property. One of the greatest things professional property management buys you is time.

It is not necessary, however, to hire a third-party management company to save time. A lot of people will use family members such as older children or their spouse to help alleviate the pressures that come with managing a property. Maybe your spouse will help with the accounting and a child will help with the maintenance. One thing to remember is that while your family will be well

intentioned in helping out, they may also be inexperienced.

We had time-poor people in mind when we started a company to manage individual investment properties. This company was a full-service, on-site property management company that offered management services with our condominiums to individual investors. It was a huge success for sales, but a strain on my company as a whole.

We sold over 750 condominiums with this management product, and every month we had to produce over 750 financial statements for 750 different owners. Additionally, we had to hire many people solely dedicated to taking calls from the owners because it was becoming a more than full-time job to interact effectively with 750 people, some of whom had never owned an investment property before and had valid but time-consuming questions.

Everything took more time and effort. When we did a maintenance job, we had to have our maintenance technicians keep track of the amount of time they spent in each unit so that we could bill back correctly. My leasing staff had to constantly field calls from owners throughout the day. My accounting staff had to make sure deposits and other income were distributed correctly to the 750 owners. It was a pain in the behind for us, but great for the time-poor investor. The average monthly cost for this service? Only \$80.

My point is this: A lot of people think that managing a property is only picking up a rent check and paying some bills. If this book will teach you anything, it's that that couldn't be further from the truth. Property management is an intensely time-consuming activity, and unless you really enjoy it, it can be a drain on you, your time, and your family.

Market Conditions

Another thing to pay attention to when you are determining whether to manage your own property is the condition of your property's market. I hinted at this earlier in the chapter when we talked about fee structures. The fact of the matter is some markets are much more management-friendly than others.

An example of this would be Coronado Island on the coast of Southern California. My family and I have rented a two-bedroom condo on the beach. I gladly have paid in years past \$7,500 per month. I'm lucky to get the place at all. Demand is so high in Coronado that summertime rents have risen to ridiculous levels.

So what does this mean about the effort that is involved in managing a place

in Coronado? Well, for one thing the fact that demand far outweighs supply means that a property manager can probably rent their unit with their eyes closed. They could do it in their sleep practically. Additionally, the high demand causes people to lower their standards. You don't complain about slow response of a maintenance person when you feel you were lucky just to get the place. A high-demand, low-supply market means that the landlord has much more control over you as the renter than in a more balanced market. Thankfully, I've had nothing but good experiences when it comes to our two-bedroom unit, but that isn't always the case in places like Coronado.

A two-bedroom unit for \$7,500 may seem astronomical to you, and it should. It is a little more than the standard rental amount for the area, but I'm more than willing to pay it because the management company that rents the unit offers a high level of service. One thing to always remember is that in a strong market, a higher level of service will make you stand well above the crowd and allow you to command even more in rents.

Also, as strong as Coronado's rental market is, it is seasonal. So there are vacancy challenges to be faced once the summer is over. There are, however, markets where the demand is so high and supply so low all year round that it is relatively easy to manage a property. Probably the most obvious example is Manhattan. The market in Manhattan is so much in favor of the landlord that the government got involved by passing rent controls.

In a market like Manhattan, one of the most time-consuming aspects of management—finding a resident—is nearly nonexistent. It would be much easier to be an owner-manager in Manhattan than in a struggling rental market.

Conversely, the town where I live, Fountain Hills, is a small bedroom community that lies northeast of Scottsdale. Practically everyone in Fountain Hills owns their own house and commutes to Scottsdale or Phoenix for work. The employment base is very low. The question begs to be asked: Why would anyone want to rent here? The answer is most people wouldn't.

Fountain Hills has the disadvantage of being a very difficult place to rent because of a lack of demand. While there are only two apartment buildings in town, many investors also try to rent out their condominiums with little success. Units can sit vacant for months.

In a slow market like Fountain Hills, the residents have much more control over their situation than in places like Coronado and Manhattan. They demand the same high level of service, but at a lower price. Additionally, they can negotiate price and terms, causing even more lost income to the owner. It takes a

lot more time and effort to rent apartments and keep renters in an underperforming market.

In the end, you need to be honest with yourself about whether it is financially and holistically sound for you to manage your own property. If you decide that you do want to manage your own property, more power to you. Make sure to use the principles I talk about in this book. If, however, you want to explore the option of a third-party management company, then there are a number of things to consider. The next section will explore the process of finding a good property manager.

Section 2

How Do I Find a Good Property Manager?

Chapter Five

Not All Property Management Companies Are Created Equal

In the summer of 2002, owners that we already managed one property for approached me to manage another property for them—the very same property I briefly talked about in my introduction. The 100-unit building was in a very rough part of town. I went out to the property and was shocked on my initial walk-through. Very rarely had I ever seen a property that was so disastrously managed.

There is no doubt that the property faced challenges given its location, but it seemed as if the manager had given up on the building. I could immediately tell that managing this building was going to be a challenge of the first order. Luckily, I enjoy challenges. Because of my relationship with the owners, I elected to take on the management of the property.

The first problem the owners had was they had signed a property management agreement that was fee-based rather than based on a percentage of the income collected. As I indicated earlier, if you are going to use a third-party management company, you should always make sure they collect their income based on the property's income. It is just too easy for someone to become complacent if they know the money will come in no matter their performance.

Even though I enjoy a good challenge, I still had huge reservations about taking on the task of managing this property. For over two months, the owners and I went back and forth on negotiating terms that would be fair for me to accept the job. There was such a large amount of outstanding unpaid bills that I made it a condition that the owner bring all accounts up to date before we even

stepped foot on the property, which they did. We needed this to happen to even have a fighting chance of fixing the problems the property faced.

When we finally did take over the property in March of 2003, we were shocked at the condition and state at which it was operating. Immediately, we walked each of the 100 units. We found significant deferred maintenance. Nearly every unit on the property required a large amount of renovation work, including the occupied units. Not only that, the deferred maintenance was so significant in about forty units that the previous manager had not been able to rent them. The property was only 60 percent occupied. Many of the vacant units required \$2,000-14,000 each just to be rent-ready. In the end, ninety-eight units needed work of one variety or another with a total bill of \$106,000!

Because the property was in such a state of disrepair, rents were significantly below market, and once we began to dig into the financials we found some pretty astonishing things. Shockingly, the rent income was about \$145,694 below market. Based on a 6 percent capitalization rate, that alone devalued the property by \$2.4 million.

Operating expenses were too high as well. The previous manager had not explored any ways to save money. A couple quick phone calls on our part saved about \$20,000 annually in operating expenses. Unfortunately, that savings and some others had to go toward expenses to make the property rentable. Even worse, we discovered that the mortgage had been intentionally paid short by about \$20,000 by the previous management company, and the lender was threatening foreclosure.

It was the owners' intention to sell the building since it was such a burden. This, however, was a futile effort. The actual cash flow for the financial year ended up being *negative* \$166,373! That was an operating loss that equated to 4 percent of the entire value of the building. That means that the building was actually unsellable, since as we've discussed, value is based on operations. Had they tried, I think the owners would have had a hard time *giving* the building away.

Once a manager gives up on a property, as the previous manager had, the resident profile will inevitably slip. Such was the case with this property. Desperate to just fill apartments, the manager stopped doing background checks and rented to anyone who came through the door, a last-ditch effort to increase occupancy. Criminal activity got to be so bad on the property that the standard street beat police wouldn't go there. Instead, they had actually set up a police substation inside the property itself because of the incessant drug activity.

Additionally, the police department had rented an apartment and was conducting sting operations on the residents.

As I mentioned in my introduction, one resident was so involved in drug trafficking that he had been paralyzed from one of the many gunfights he had been in and was wheelchair-bound, and he had his wheelchair custom-built so that he could hide an automatic weapon in it. When we first took over the management of the building he was very nice and very interested as to what we were planning on doing to increase security. He was worried how it might affect his business!

We immediately evicted fifteen people when we took over the property because of their involvement in criminal activity. One of my employees went so far as to jokingly suggest we apply for federal funding to become a halfway house for convicted felons. That might have been easier.

We faced a mountainous volume of work when we took over the property. In trying to get the property back to a functioning level, the workload was so intense that I had my corporate office employees keep track of the time they spent on it. The results were astonishing. Following is the actual monthly time and cost of my corporate staff on just this one property:

	<i>Time Commitment per Month</i>	<i>Cost of Time</i>
March		
Asset Manager	60	\$1,920
Accounting	56	\$1,400
Training	12	\$240
		<hr/> \$3,560
April		
Asset Manager	50	\$1,600
Accounting	31	\$775
Training	6	\$120
		<hr/> \$2,495
May		

Asset Manager	50	\$1,600
Accounting	31	\$775
Training	6	\$120
		<hr/>
		\$2,495
April		
Asset Manager	50	\$1,600
Accounting	31	\$775
Training	6	\$120
		<hr/>
		\$2,495
April		
Asset Manager	40	\$1,280
Accounting	31	\$775
Training	6	\$120
		<hr/>
		\$2,175

Let me tell you why this chart is so significant. When I negotiated the property management agreement with the owners, I wanted there to be some safeguards because I knew there would be a lot of work involved. With that in mind, we settled on a management fee of 5 percent of the total income collected, or \$2,500 per month, whichever would be greater.

When we took over the property it was generating about \$31,000 in total income each month. At 5 percent our monthly fee would have been \$1,550. Thankfully, we had a safeguard and collected \$2,500. Unfortunately, I still lost money.

Earlier in the book I talked about the things a property's operating income pays for. One of them is the on-site staff: your manager, maintenance, housekeeping, and leasing agents. It does not pay for the property management's corporate office staff. Take a look at the chart again. Do you see how on the first month we took over the property the total cost to *my* office staff was \$3,560? That was a direct loss to me of \$1,060. From then on it was basically break-even.

All of this was a direct result of the previous manager's inability to manage the property correctly, and all of this could have been avoided if the owners had done a little more homework and been more prepared in their initial search for a property manager.

In the end we were able to get the building into a much better operating status. The difference was so dramatic that the owners actually changed the name of the building in order to shed the negative stigma of the previous name.

After our hard work, the owners were able to sell the property and even realize a little profit. That would have been unthinkable two years earlier. This is proof positive to me that there is nothing more important to the value of a property than good property management. Think of the stark contrast; one manager had driven the property so far into the ground that it was technically worth nothing, while we took the same property and created value just by implementing sound management principles.

To me there is nothing more tragic than seeing a property's value destroyed by a manager's bad performance. Unfortunately, this property's story is not an isolated case. The responsibility rests on your shoulders to do your homework when hiring a management company. In this chapter we will discuss how you can avoid these mistakes and find a property manager that fits your investment's needs and manages your property successfully.

What You Need

First off let me say the simplest definition of a good property management company is this: one that sends you a check and never calls. That is the dream of every real estate investor. One of the major advantages about hiring professional property management is that you no longer have to invest copious amounts of energy and time in your property. When you have a property management company that you trust, you let them take care of your asset and they send you the returns. If you feel the need to control every aspect of the property management process, you should just manage the property yourself. Otherwise, you defeat the purpose of hiring a professional company and you are wasting your money. However, this does not mean you should not be managing the property manager.

Though it is easy to blame a property management company if your property is underperforming, the responsibility ultimately is with you. Even if you are not going to manage your own property, you need to have a fundamental understanding of the work and principles that are needed in order to make your property a success and grow in value. You should choose your management company based on an informed decision.

There are many property management companies out there who are dying for your business. A lot of companies will take on your property, even if they don't have the manpower or the know-how, because they are more concerned about growing their business than creating value for your investment. Not all property

management companies will specialize in managing your type of investment. Later in this chapter we will go into detail about the various types of companies, but for now suffice it to say you shouldn't hire a company whose expertise is commercial management to run your ten-unit residential building.

The first thing you should do when evaluating which company to hire is to evaluate your property needs. Sit down and think hard about what kind of property you own. Make a list of the needs of the property that will have to be addressed by the management company you hire. Some areas to focus on are:

Age

If your property is older it will need to have a higher level of maintenance in order to keep it competitive.

Structures Some properties will have more than just one building. There might be fountains or sport courts. Another common building would be a laundry facility. All of these will require a company that has knowledge of how to care for these items.

Equipment Oftentimes a property will come with equipment that assists with the care of the property. I recently purchased a property that came with a snow plow, a truck, and a car. There were also boilers that provide hot water to the residents. These items are part of the property and will need to be managed and cared for.

Grounds The landscaping on a single-family home may take very little work. If you own a larger property, however, it is a major expense and takes a lot of time. If a company doesn't have the resources to manage your landscaping, your property will suffer.

Local Each state and the cities within those states have varying laws and regulations on laws the rental industry. Be sure that a company is not just familiar, but well informed about your market and its laws.

Amenities If you own a larger property, you will have multiple amenities such as pools, fitness centers, and business centers that will need to be cared for on a continual basis.

Administrative Needs Determine if your property needs an on-site or off-site manager. Also, determine what kind of accounting functions and reports you will want to see. Make sure a prospective company can meet those needs.

Size Whether your property is a single-family home or a large multifamily apartment building, there are companies that will specialize in your type of property. Don't make the mistake of hiring a company just because they want the business. Find the right fit.

This doesn't have to be anything extremely complicated. For example, if you own a 100-unit community, you don't want to hire a company that doesn't offer *on-site* management and trained maintenance technicians. *Conversely*, if you own a single-family house, you probably don't want to hire a large company that will find it too easy to let your small property fall through the cracks.

Additionally, your property's needs will vary depending on the region. You may own a large property that would benefit from a large property management company, but if it is in an area where that company's presence is small, you could be better served by seeking out a company that knows the market and has a presence.

Something as simple as the climate can create dramatic differences in the needs of comparable properties. A property in Madison, Wisconsin, would need to have ways to manage snow accumulation, icy pipes, and slick sidewalks, something a property owner in Phoenix, Arizona, would never have to worry about. If you own a property in a cold weather climate like Madison, it wouldn't make sense to hire a property management company that operates primarily in the Southwest. There is such a vast difference between the climates that there is no way the company could be as well versed in managing a property as a company that operates locally or regionally.

A good rule of thumb when evaluating a property management company is to make sure that it belongs to local and national trade organizations. Reputable companies belong to trade associations. Belonging to a trade association is an indication that the company is focused on improving its operations. These associations offer training for employees, networking opportunities, and valuable market research that a company can get nowhere else. You can find a list of prominent property management trade associations on the NAAHQ.org and IREM.org Web sites.

I have been involved in the Arizona Multihousing Association (AMA) for years. Every month I send my employees to any number of the training classes that they offer. These classes are invaluable. Additionally, our involvement in the AMA has created valuable networking opportunities with vendors that we have used to negotiate discounted services. This saves my clients money.

The AMA also keeps all its members up to date on changes and proposed changes in the Arizona legal system that would affect how a property is managed. They provide educational forums and seminars on property management law and help me ensure that my employees are empowered with the knowledge they need to comply with those laws.

Trade organizations also provide certifications based on intensive training.

The National Apartment Association provides a Certified Apartment Manager certification that takes hours of classroom and practical application to obtain. Also important are the crime-free certifications that these organizations provide. In Arizona, all of my properties have obtained five-star certification, a program that has partnered with the state of Arizona to help reduce crime in apartment communities. It is a difficult certification to obtain, and one that I am very proud of.

Types of Property Management Companies

As I mentioned earlier, there are many different types of property management companies. The types of properties you will find companies specialize in are:

- | | |
|--------------------------------------|--|
| Commercial | <ul style="list-style-type: none">• Manages commercial buildings ranging from small offices to large skyscrapers• Leases to companies, not individuals• Cares for exterior and common aspects of commercial properties primarily• Enforces policy• Generates multiyear leases• Collects money from companies and manages commercial financial accounts• May offer space planning and architectural services• May offer leasing services• Off-site and on-site management |
| Home Owners Association (HOA) | <ul style="list-style-type: none">• Manages common-owned properties such as condominiums, master planned communities, and subdivision housing• Generally manages only exterior elements such as the landscaping, building exteriors, roofs, parking lots, etc.• Enforces HOA policies• Manages HOA accounts, collects HOA dues, and pays HOA bills• Does not lease• Off-site management |

Mini-Storage

- Manages storage facilities
- Offers high level of security to protect individual's stored belongings
- Takes care of exterior aspects of property only
- Collects monthly rents for each storage space
- Leases on a month-to-month basis
- Enforces storage policy
- On-site management

Shopping Centers/Retail

- Manages shopping facilities ranging from small strip malls to large shopping centers
- As with commercial management, rents to companies, not individuals
- Maintains exterior and common areas of property primarily
- Collects rents and manages financial accounts
- Generates multiyear leases
- Enforces policy

- Off-site and on-site management Multifamily
- Manages medium to large multi-unit apartment buildings
- Maintains exterior and interior of buildings
- Collects rents and manages property financial accounts
- Enforces policies
- Generates monthly to yearly leases
- On-site management

**Single-Family/
Small Property**

- Generally manages single-family and duplex type investment properties to medium-sized properties
- Maintains exterior and interior aspects of property
- Collects rents and manages financial accounts
- Enforces policy
- Generates monthly to yearly leases
- Off-site management

There are other types as well, but these are the major ones. Each of these property types has specific needs that require a property management company well versed in those needs.

Beyond specializing in a property type, companies also differ in their operational capacity, each of which will have its pros and cons:

**National/
International**

Pros

- Large well-established company with name recognition
- Generally has standardized systems and policies
- Generally mandates training and education of employees
- Will be highly involved with professional trade organizations
- Knowledgeable about legal aspects of management
- Large employment base that can absorb employee turnover
- Sophisticated accounting systems
- Sophisticated marketing systems such as comprehensive Web sites
- Offers on-site management
- Can perform high level of maintenance
- Sophisticated purchasing power

Cons

- Smaller properties such as less than 50-unit buildings can get lost in the fold
- May not have in-depth knowledge of your market specifically
- May not have relationship with local vendors
- Will not manage single-family or duplex type properties
- Often will be very red-tape oriented

Regional

Pros

- Will specialize in the local market
- Has well-established network of local vendors
- Tendency to be more enthusiastic about small properties
- Will generally be involved in the local trade association
- Understands local legal issues
- Will have good systems and policies
- Locally established and good reputation
- May offer more personalized service
- Offers on-site management
- Can perform basic to medium-level maintenance

Cons

- May not be able to absorb the loss of key employees
- May not have the capability to manage large multifamily buildings
- Cannot manage effectively outside its region
- May not have strong training or education programs
- May be eager to grow, and will take on properties regardless of qualifications to manage them
- Single-family and duplex type properties may play second fiddle to larger clients

Mom-and-Pop

Pros

- Tends to specialize in single-family and duplex type properties
- Highly personalized service
- Good knowledge of local market
- Less expensive than larger companies
- Can perform basic maintenance

Cons

- May not have sophisticated systems
- Cannot absorb loss of employees
- May be eager to grow, and will take on properties regardless of qualifications to manage them
- May not offer training or education to employees
- Cannot manage medium to large properties
- Does not offer on-site management

Realty Company

Pros

- Tends to specialize in single-family and duplex type properties
- Will have good knowledge of local market
- Will have sophisticated marketing systems such as Web sites
- Less expensive than larger companies

Cons

- Management not primary focus of business
- May not offer training or education
- Cannot absorb loss of employees
- Cannot manage medium to large properties
- Does not offer on-site management
- Will not be involved with trade organizations
- Will outsource most maintenance

Owner/Resident Management

Pros

- Least expensive form of management
- On-site
- Can be used for smaller properties
- Can perform low-level maintenance

Cons

- Will not have professional training or education
- May not be fully aware of legal issues
- Not primary source of income
- Lacks sophisticated systems
- Lacks local contacts with vendors
- Will not be involved with trade organizations
- Can be unreliable

My company specializes in large multifamily management in the Southwest. I get offers all the time to manage outside my specialization. I always say no. In my previous book, *The ABCs of Real Estate Investing*, I wrote extensively on the importance of setting goals. I believe that “goal power” is the key to success. When it comes to my management company, my goal is to be the most successful property management company in the Southwest.

Earlier in the book I talked about the property that we purchased in Oklahoma City. I had no desire to manage that property so we turned to local professionals. Attempting to manage the property ourselves would also take the focus off my goal of buying property. My Oklahoma City property is part of a different, but complementary, goal to be financially free.

As an investment property owner, you need to begin your search for a property management company by evaluating what type of property your investment is and what its specialized needs are, and then find a property management company that fits well with those criteria. It is an important decision and one that will take a little bit of research on your part. As with all good investments, if managed well, yours will reap great rewards down the road.

Chapter Six

Employees, Systems, and Structures: The Backbone of a Company

There are three things that make a company great: their employees, their systems, and their structure. All three of those things have to be polished and excellent in order for any company to be successful. You cannot have one without the other. If you have the best employees in the world, they will do no good if sound systems aren't in place for them to operate in. A great manager cannot be successful if they don't have accounting support. Conversely, systems only work if a company has employees that are trained and can utilize those systems to create value. A company's structure allows for seamless interaction between an employee and the company's system. Structure allows an employee to know their role and to focus on being successful.

Employees

TRAINING

When you are evaluating which company you will hire to manage your property it can be easy to forget that you aren't hiring just a company. You are hiring the people within that company. That was the mistake the owners of the West Phoenix property made. They hired a company that had a good reputation, but did not look past the macro to the micro. An interview with the person that was going to be actually on the ground, managing their investment, might have caused them to think twice. I would go so far as to say that the individual a company uses to manage your property is more important than the company

itself. After all, you will be dealing primarily with the manager, not the company.

One sign that a company has good employees is the level of education they provide. All of my employees have monthly, ongoing training. I invest in my employees, knowing that the investment will foster growth in both my business and in my employees.

Take a close look at a prospective company's training systems. A good company will have a training program that focuses on creating top-notch property management employees. For instance, Equity Residential, one of the nation's largest management companies, has its own "university." Through Equity University, the company ensures that all its employees attend and graduate from an intensive and standardized training program.

Other companies will utilize corporate trainers. I bring in a corporate trainer every month to work with my managers. She specializes in developing management skill sets in a fun and interactive way.

You might assume that all companies take the time to train and educate their employees. Unfortunately, that is often not the case. Too often companies leave it in the hands of their employees to train themselves. Beware of a company that doesn't standardize and require training.

JOB SATISFACTION

Take a look at the management company's employee retention. A good company attracts and retains good employees. If there is a lot of turnover in a company, you can bet there is something going on internally—and it probably won't be good for your investment. Good companies know the value of their employees and strive to keep them happy and therefore with the company. I learned the value of this lesson firsthand.

Rich Dad Tip

Poor Pay = Poor Morale

Poor Morale = Poor Profits

At one point we converted one of my properties in Las Vegas from apartments to condominiums. When the property was almost sold out we contracted a home owners association to manage the property. An HOA is a little different from a multifamily management company in that they only manage the common area of the buildings since the units themselves are owned by individuals. HOA companies need to be well versed in legal and financial systems that are quite a bit different from other management types.

My company doesn't perform HOA management, so we hired a company to do it for us. It was a disaster. I knew we were in for trouble when the manager quit a week after we hired the company. Then the new manager quit a couple months later. Both managers quit because of internal structure issues. They were frustrated with the company, which made them frustrated with their jobs, which made them leave.

Owners on the property started to grumble about the lack of maintenance. If you think it would be bad to deal with one angry owner, try 340 of them. HOA meetings turned into three-hour-long complaint fests, as one owner after another came forward. Over the course of time this company was under our employment, we had five property managers come and go. Finally we said enough is enough, and fired them.

Systems

Earlier in the book we went into detail about sound property management systems and how to implement them. If you aren't planning on managing your own property, then you had better be sure that the company you hire is firing on all cylinders when it comes to property management systems.

POLICIES AND PROCEDURES

One of the best ways to get a feel for a company's level of professionalism is to take a look at a company's documented policies and procedures. In my company, every manager on-site has a copy of a standardized policy and procedure manual. They are expected to know it by heart, educate their staff about it, and enforce the policies contained within it.

ACCOUNTING

Though a manual is good for detailing on-site operational systems, it is important to determine what kind of systems a company has in place for accounting as well. If a company doesn't have an excellent, autonomously functioning accounting department, you can bet for sure that the employees on-site will not be able to do their job effectively.

I thank my lucky stars that when I first started in the property management business my company had excellent corporate accounting and support systems in place. Having those taken care of allowed me to focus on managing my properties without worrying about the accounting details. I collected the rent and paid the bills, while accounting produced reports for me that enabled me to make informed and effective decisions. I wouldn't have survived without them.

Structures

The structure of a company determines its ability to operate successfully. I can think of nothing more important when it comes to a company's structure than depth. You should be leery of a company that cannot absorb the loss of an employee in any of its departments.

Accounting is the most apt example for this. As an owner, the single most important correspondence you will receive from a property management company will be your monthly and annual financials—the report card. By now you know how important financials are. They tell the story of whether your property is succeeding or not, whether your investment is growing your wealth.

Financials are produced by the accounting staff at a property management company and should be sent to the owner by the 15th of the following month at the latest. When I first started in the property management business my company consisted of myself and an office manager that knew how to do accounting. Most property management companies that you will come across are small like mine was. Generally they will have two to five employees. In the early days, if my accountant were to leave at the end of the month, there would be no way that I would be able to get the financials out to my clients. I would have had no way to absorb the loss of my accountant.

In larger companies, however, the loss of a key employee is not nearly as crippling. The same accountant that I had in the early days of my company is still with me. She is now my regional accounting manager. She has been with me for over 18 years, and is a major part of the growth of my business. God forbid

she ever left, but if she did, my company would still function smoothly. She manages competent people who could step up and help, and my CFO could oversee the process. Financials would still be sent to my clients on the appointed day, and as far as my company's operations are concerned, they would never know the difference. In a large company, even the loss of a key person can be absorbed and business will function as normal. That is not the case with smaller companies.

Don't get me wrong, I'm not saying, "Don't hire a small property management company." Obviously, if people had followed that line of thinking I would never have gotten off the ground myself, and you wouldn't be reading this book. For the record, there are a lot of quality small property management companies out there, and one of them may fit the management needs of your investment property perfectly. While depth will be an issue with these companies, that doesn't mean that the benefits of a small company won't outweigh the disadvantages.

For example, if you own a single-family investment property as my in-laws do, a large property management company won't be your best bet since they are most likely managing large multi-unit buildings. In some cases they wouldn't even consider taking on a single-family house. Such is the case with my company. The reason is that it would be too easy not to give your investment property the attention it deserves. It would often get put on the back burner. If I had an issue with a multi-unit account that brings in \$5,000 per month in management fees and an issue with a single-family house account that brings in \$100 per month, which property do you think I'd focus on? In the case of a single-family property, a smaller management company would be much more inclined to give your property the attention it would need to be successful. I can't stress this enough: You should always hire a property management company based on what fits the needs of your property.

Finally, one last thing to take a look at when evaluating a property management company is the stability of its portfolio. Do they have properties that they have been managing for years, or is their portfolio a revolving door? You can bet that a management company whose portfolio is always shifting is probably not offering a satisfactory level of service.

Section 3

How Do I Hire a Good Property Manager?

Chapter Seven

Hiring a Good Property Manager or Management Company

By now you should have a pretty good understanding of the amount of work and effort that is involved in managing a property and whether it is for you. We've discussed the qualities you must have or develop—most importantly, assertiveness. You have analyzed your working situation and determined whether managing your own property is a reasonable and cost-effective use of your time.

If you decide that managing your own property is not for you, you now know the attributes you should look for when hiring a property management company. You're now equipped with the tools to scrutinize another property and compare management companies' systems. In this chapter, I will show another invaluable method for researching potential property management companies.

If you read my previous book, *The ABCs of Real Estate Investing*, you will remember that I told you about a property we acquired on the waterfront in Portland, Oregon. You will also remember all the work we did in researching whether to purchase the building. In that section, I showed you my own personal method of researching, which I group into three, easy-to-define and easily understood categories:

- | | |
|------------------|---|
| Level 1 Research | Preliminary research that you can do from your own home. This would include Internet and publication research. |
| Level 2 Research | If Level 1 research leads you to like what you see, Level 2 research will be needed. This is the stage where you meet |

face-to-face with people in the know. Level 2 research is invaluable in verifying the information you gathered in Level 1.

Level 3 Research

Level 3 research involves utilizing the experts you have already assembled on your team. Call them and run your information past them. They will give you valuable insights. This will allow you to remain objective and keep perspective.

Our intent in Portland was to purchase an apartment building and operate it through third-party management. Knowing my goal for my company to be the best property management company in the Southwest informed my decision to hire a company to manage the property in Portland.

If I spent so much time and energy in researching the property itself, why wouldn't I spend the same amount of energy in researching who I would choose to manage my valuable asset? That is exactly what I did, and I used the three levels of research in my investigations.

Level 1 Research—Finding the Players

Level 1 research is the preliminary stage of your process. By now you have profiled your property and determined its needs. You are ready to begin searching for property management companies that will be the best fit.

When I was first looking for a property management company for our Portland property, I started with the Internet. I love the Internet. I can't imagine how I functioned without it. At the tip of my fingers is access to incredible amounts of useful information that would have taken weeks to assemble a few years ago.

I started my online search with the local apartment association, the Rental Housing Association of Greater Portland (RHAGP). Just by going to their Web site I was able to access the contact information of over fifteen local property management companies. I printed out the page listing them and put it in my file.

Also on the RHAGP Web site I was able to read through the local newsletter and get a feel for the players in the local property management market. I printed out back copies of the newsletter and put those in my file too, to read on the plane. I used those for my Level 2 research in order to help me narrow down my list of whom to meet when I visited the city.

Not wanting to be limited to just local property management companies, I

also visited the Web sites of some regional and national companies, such as Equity and HSC. Through browsing their Web sites, I was able to determine that each one of these companies had branch offices in Portland staffed with account representatives that I could meet with. I was also able to get a general history of each company, an idea of its business philosophy, and a listing of the properties that it managed in the Portland area. I took down the contact information and addresses of these apartments so that I could tour them while I was in Portland and contact their owners.

Contacting a property owner is an invaluable tool in your search for a property management company. It's a safe bet that someone who is entrusting the value of their investment to a property management company will shoot straight with you when you ask them about the performance of that company. In this case, one of the owners informed me that he was looking to make a change and was not happy with a company's performance. I was able to confirm this feeling with a few different owners and used that valuable information to scratch that company off my list. Remember the old saying, "You have not because you ask not"? When it comes to real estate, asking an expert a simple question can save you millions of dollars.

Now that I had a good handle on the players involved in the Portland rental market, it was time to focus my list and decide who I wanted to meet when I traveled to the city for my Level 2 research. Again, I accomplished most of this from the comfortable confines of my office chair through the magic of the Internet and my phone.

The local property management companies that I had found online all either had a Web site or a phone number. By calling or browsing their Web sites I was able to determine which companies may be a good fit for my property and which would not. Once I had my list of companies that I was interested in, I called each of them and set up an appointment with one of their account representatives, letting them know I would like to meet them at their office.

Level 2 Research—Meeting the Players

The first thing I did when I arrived in Portland was...grab one of the famed local beers. Level 2 research is a blast. You get to travel to awesome cities and meet incredible people, and it can all be written off as a business expense. To me there is nothing more exhilarating than being able to travel to a new area, meet new people who will help me achieve my business goals, and either confirm or

realign my thinking about a certain market.

As I mentioned, I had set up appointments to meet with property management companies before I even left for Portland. I had three companies in mind to manage the property and planned on spending a day with each in order to observe and to really sink my teeth into their operations. I had very clear objectives in mind and very specific things that I wanted to observe.

THE OFFICE VISIT

When looking to hire a company you should always visit its offices. This isn't about cosmetics. Who cares if it has green carpet and you prefer gray. Visiting an office is all about observing the way in which the business operates. It is also an opportunity to review some documentation that will be vital in your decision-making process.

Keep your eyes open, and observe the office staff. Does it seem organized or chaotic? Is there an air of professionalism, and are the employees dressed neatly? Check to make sure there is a clean and efficient filing system. One company I visited had files stacked on tables. Needless to say I was not impressed. If a company can't keep their paperwork in order, they definitely won't be able to keep your investment in order. All of these small visual clues will give you insight as to how the company will manage your property.

Ask to use a conference room and sit yourself down with the employee manual and the property policies and procedures. Read them thoroughly and ask any questions that you might have about what, and what might not, be included in the material. Don't be afraid to ask the tough questions. This is not a time to be timid. This company may be managing your valuable asset and you should investigate and learn as much about it as possible.

Meet with the manager and asset manager that will be assigned to your property should you hire the company. Remember what I said earlier, even more than the company itself, you will be hiring the people that will be physically working on your property. Ask them about their certifications and their experience in the industry, and ask to see proof and a list of references.

Inquire into the education systems that the company has in place and determine whether they are current in their involvement with the local trade association. Have them explain their philosophy when it comes to training. Oftentimes, when employees take training or an educational course they will

receive a certificate of completion. Ask to see those certificates for the people who would be working on your property. You would be surprised, but a lot of times a company will say they are actively training their employees even when they aren't. Don't just take a company's word. Trust but verify.

Of course you'll want to review the company's accounting systems. These should be spotless. Don't get involved with a company that doesn't have a solid accounting staff. Determine what software the company is using. An added benefit of hiring a management company is that they should have sophisticated financial software in order to provide you the owner with a high level of financial service. If they are running reports only through a rudimentary Excel spreadsheet you might want to think twice.

Talk with the accounting manager. Ask them what types of reports you will see on a monthly and annual basis, and get a feeling for their experience level and education, as well as that of their staff.

Find out what kind of financial services the company provides. Do they pay your mortgage for you? Do they handle the insurance and tax impounds? The more sophisticated the accounting systems the more likely you will be able to enjoy your investment hands-free, and that will allow you to follow more investment leads or indulge in a hobby. The whole point of property management is to take the burden of dealing with the operational details of your property off you and place it on the company. Verify that the company creates separate accounts for each property and that there is no commingling of funds. Determine how they collect and manage your money.

You should also request a list that details all the properties that the company manages. Ask for the whole list. A lot of times a company will provide you with a hand-selected list that reflects their best properties and happiest owners. You want the good, the bad, and the ugly.

Spend a day visiting the properties that are on the list and do the same kind of in-depth observations on the sites that you did in the office visit. Nothing will tell you how a property management company will take care of your investment like visiting the properties that company is already managing. In the industry we call this "shopping" a property. Shopping should always be done anonymously. You'll never get a true picture of the company if you announce to everyone that you are a potential client.

Here are a few things you should really key into when shopping a property or a company's employee. This list would generally be used for larger properties; however, remember, size doesn't matter, as most of these items are obvious

customer service and training issues. Even if you aren't looking at hiring a big company, you can still visit properties and get a good feel for the way a company manages by observing the exterior condition of their properties.

- Property Condition**
- When you first drive onto the property observe the condition of the landscaping. Is it pleasant, or does the grass need mowing and are weeds popping up everywhere?
 - Make sure the property is clean. Look to make sure there isn't trash lying around.
 - Observe the condition of the buildings, paying special attention to any obvious deferred maintenance and capital items such as broken windows, stucco and siding damage, old paint, and other signs of neglect.

- Clubhouse**
- On larger properties there will be a clubhouse that generally contains common areas for residents to use and houses the staff offices.
 - Ask yourself what kind of first impression you get by walking into the clubhouse. Is it clean and free of clutter?
 - Is it clear where the rental offices are, or do you have to hunt around hoping to find someone? Nothing is worse than a potential resident who has been touring apartments all day becoming frustrated because they can't find a leasing agent.
 - Observe whether there is rental material out for potential residents to review such items as floor plans, brochures, and rental pricing.

Staff

- When you walk into a rental office, someone should approach you immediately.
- Observe the staff, taking note of their appearance and demeanor. A good company will have employees who are professionally dressed, energetic, and give the impression that they are genuinely excited to show you the property.
- If you have a chance, observe the way in which the staff interacts with residents when they come into the office. A good way to do this is by shopping a property on the first of the month. Everyone will be coming in to pay rent.
- Ask lots of questions. Make sure the employees are well versed in not only the property but also the company's policies and procedures. Unless they are newly hired, if a leasing agent can't even tell the rent on the property floor plans without referring to a cheat sheet, or tell you how many units the property has, that may be a troubling sign.

Collateral/ Marketing Materials

- On larger properties there will generally be marketing materials such as brochures, flyers, and business cards.

- Make sure these materials are professional-looking, and not poor copies that appear in-house. Collateral is a huge factor in making a solid first impression. Never forget that people are not just renting an apartment, but a lifestyle.
- The marketing materials should be placed in an open and readily accessible place.
- Verify the accuracy of the marketing materials. Nothing makes a worse impression than having a leasing agent tell you that a rental amount or lease special is different from what is printed. Not updating printed materials is a serious sign of laziness.

Tours/Models

- The most important factor for a prospective resident in determining whether to rent or not will be the model walk or touring of units.
- Make sure that the person who will be touring you gets all your information and fills out a guest card.
- Ask to see the models or the units for rent and observe the sales presentation.

- Observe the condition of the models or units. Are they clean and stylish? Do they get you excited about living at the community, or are they forgettable?
- Is the person touring you commanding the tour, or do they seem uncomfortable?
- Again, ask lots of questions. Don't interrogate them, but do pay attention to whether the employee remains attentive to your questions or whether they seem to be getting impatient.
- After the tour, the leasing agent should have immediately tried to get you to lease. The hard close.

Office

- While you don't need to apply for an apartment, you should show interest and sit down with the leasing agent.
- Observe the condition of their offices. Are there files stacked everywhere, cups of half-finished coffee, and papers littering the desk? Do they have to make a space for you? Any signs of disorganization are bad.

Once you have visited the property management offices, talked to the staff, received advice from other owners, reviewed the policies and procedures, and shopped or visited sample properties, you will have a pretty good idea of who will be a good fit to manage your property. Now you should grab one more of the local brews or visit one more local attraction and head back home to begin the third level of research.

Level 3 Research—Picking Your Player

You can think of picking your management company like the NBA draft.

NBA players are valuable commodities. Think about all the work and preparation that goes into scouting an NBA player. Some teams follow a basketball player from the time they are in high school all the way through

college—if they go to college. In some rare cases, players are scouted from junior high and on.

Teams will send scouts all over the country, paying them high salaries, keeping them in fancy hotels, and feeding them steak dinners. All this is done so that they can determine which player the team will eventually draft in order to pay even higher salaries, provide stays at even fancier hotels, and pony up on even steak-ier dinners. NBA teams will spend a lot of money in research just to try to pick the one player that will take them to the next level.

Why all the fuss? The NBA is a billion-dollar business, and the stakes are high when they get to the draft table and it's their turn to pick a player. You may think that the player salaries are out of control, and you might be right. The fact of the matter is that the players make the owners insane amounts of money—if they play well. All the money a team invests in researching players comes back many times over if they make the right pick. Unfortunately, the odds aren't that great.

Thankfully the odds are much better when you are picking a property management company, but the stakes are just as high. If you don't do your research correctly or neglect to do it at all, then the results could be staggering. Remember the property in West Phoenix that my company took over because of our business relationship with the owner? That property was just 100 units, yet it cost them millions of dollars. They didn't draft the right player, and the property failed because of it.

When hiring a third-party property management company I cannot stress enough how imperative it is that you make a wise, well-informed decision. That is why it is vitally important that you consult your team. Don't just go by your observations. You need another set of eyes. That is just a sound business principle. Even in writing this book, I had a dozen close friends read the drafts and give me their honest opinions. If I had just finished a first draft and said, "This is as good as it can be," I wouldn't have felt good about the final draft.

Level 3 research is the time when you will be able to run your findings by your team of experts. Talk to your property management expert and show them your thought process on the companies that you will be picking. They may have some valuable insights that you might have missed. Have a lawyer review contracts. They will be able to help you avoid any hidden traps. Call and talk to industry players in the market where your property is located. They will have a good knowledge of the local companies and will be able to confirm or modify your findings. Just by doing this, I guarantee you will be able to remove some

companies from your list, and feel just that much more confident that you can make the right choice for the new player on your investment team.

And thank goodness that the cost for your research is a minor fraction of the cost an NBA team spends in their scouting. The biggest costs are the plane ticket and the hotel. These are a small investment for how many returns a solid property management company will afford. I love the process of researching, and I think you will too.

The Management Contract

Once you have completed your three levels of research and settled on the management company for your property, you will come to the hiring stage. This will involve negotiating the management contract.

First off, you should always have an attorney review any contract that you are going to sign. An attorney will be able to tell straightaway whether a company is trying to fleece you with hidden clauses or trick fee structures.

That said, there are a few things that you should definitely keep an eye out for when evaluating a property management agreement.

FEE STRUCTURE

Be sure never to sign an agreement with just a flat fee structure. If a management company is not willing to put a stake in the financial success of your property, chances are they simply aren't worth the paper their contract is written on. A company that charges a percentage fee of the income collected will be motivated to collect as much income as possible. That will mean more money in their pocket—and yours. That's what I like to call a symbiotic relationship.

Also, it's important to remember that the percentages will vary depending on the market your property is located in. If all the property management companies in a market are charging around 6 percent for a 100-unit building, it will do you no good to try to negotiate the fee down to 4 percent. It is your responsibility to know the market your property is in and determine what a fair percentage is.

ACCOUNTING SYSTEMS

Be sure the contract is clear on when rent will be collected, when it will be

deposited, and where. It is important to make sure that your money will not be commingled with any other property's money in the management portfolio.

Determine if the agreement is clear that you will have financial control over the property, and that you can set the guidelines on spending habits for the property. Most likely according to the approved budget, there should also be clear expectations for when and how the management company will report to you on a monthly and annual basis with financials. Dates should be clear as to when all financial reports are due, and it should be no later than the 15th of each month for the previous month's operations. Be clear on the fees that should be collected and the dates on which they should be collected.

RESPONSIBILITIES

The management agreement should spell out clearly the responsibilities of the management company, and should have legal language for you as the owner if those responsibilities are not met. Remember the importance of getting everything in writing. Don't settle for generalizations. It will be much better for both you and the company you are hiring if the expectations are detailed in the management agreement.

EXPIRATION

Finally, it is important to have a clear timeline set in the management agreement. Don't sign multiyear agreements that lock you into a contract with penalties for early cancellation. The term of the agreement should be comfortable for you and match the needs of your property. Make sure to note whether the management agreement has an automatic renewal clause. These are not necessarily bad in themselves, but you as the owner should remember the date so that you can review the performance of the company throughout the year before the contract renewal goes into effect.

Owner and Management Company: A Symbiotic Relationship

In the end, remember that you are responsible for your property and how it operates. A good management company will go a long way in taking the burden off you, but don't think you can disappear from the picture and blame the

management company if something goes wrong.

Part of the beauty of having a professional management company run your property for you is that you don't have to sweat the details. Rather, you can focus on the few things that interest you such as financial review. Make sure to meet frequently with your management team, and have them give you property updates so that you can address any concerns about the way in which your property is being managed.

If you follow these steps and do your homework, you will be able to enjoy the symbiotic relationship of owner and management company. Your investment will grow in value, and you will become freer to follow your passions while your wealth multiplies. I can't think of anything better than that.

Conclusion

Now that you've made it to the end of this book, you have a decision to make. Are you going to hire a management company to care for your investment, or are you going to manage it yourself? I've given you the tools you need to evaluate your needs and what will work best for you.

Whether you choose to manage your property yourself, or choose to hire a property management company, the fact will always remain that poor management equals poor profit.

This book has equipped you with the power to change the story of your real estate investments. I promise you that if you use the sound property management principles that are in this book, or hire a company that does, your investment properties will grow in value. Always remember, the formula is simple but the details are not!

Rich Dad Tip

Increase income and decrease expense.

That is the surest way to make sure your investment property is a success. And your property's success is the surest way for you to build wealth and live free.

When I speak of living free, I'm not just thinking of freedom in monetary terms. I also mean freedom to spend time with your family, to travel, to follow your passions. That is really the desire of the Rich Dad team, and my personal desire for you and your family. We have all experienced the wonderful joy of the freedom that wealth brings. It has changed my life and it will change yours.

Resources

On the following page is a list of sample applications, agreements, and forms that you may find useful. You can find them on my website: KenMcElroy.com

Please note that they are intended to serve as samples only, and you should take into account your own specific needs and consult with your own legal counsel whenever drafting documents like these.

A Bonus from Ken McElroy...

Property Management Forms you can download... for FREE

Sample Due Diligence Checklist Keeping Track of Your Bad Debt MC Strategy for Move-Outs and Collections Apartment Inspection Form Arizona Crime-Free Addendum Sample Bad Debt Log Sample Community Policies Carpet Replacement Calculations Capital Replacement Log Resident File Checklist Move-Out Final Account Statement Collections Final Notice Guest Card Collections Sample Letter 1
Collections Sample Letter 2
Collections Sample Letter 3
Collections Sample Letter 4
Collections Sample Letter 5
Market Survey Template MC Communication Log MC Lease Packet - Arizona Move-In Cost Sheet Media Release Mold Addendum Notice to Vacate Pest Control Addendum Pet Addendum Pet Approval Letter Pet Denial Letter Pet Deposit and Fee Requirements Pet Verification Form Promise to Pay Agreement Rental Application Rental Criteria Resident Contact Update Rental and Employment Verification Forms Sufficient Heat Addendum Work Order Visit...KenMcElroy.com

Notes

Ken McElroy

Author, Principal and Co-Partner of MC Companies



Ken McElroy has nearly three decades of experience in multifamily asset and property management and development. MC Companies is a full-service real estate investment and property management group that since 1985 has developed, built and managed multifamily housing communities. Currently they own over 8,000 units in several states including Arizona, Texas, Nevada, and Oklahoma.

MC Companies believes in *Sharing the Good Life* **with its communities through donations and volunteering time to support various local and national charities.** MC Companies Team members annually donate more than 2,500 hours to local and national charities. Ken sat on the advisory boards for Childhelp and AZ Food Banks where he directed the largest food drive in the state of Arizona. MC Companies also supports the Cystic Fibrosis Foundation, Hydrocephalus Association, The University of Arizona Health Sciences Center, The Leukemia & Lymphoma Society, Salpointe Catholic High School, Susan G. Komen for the Cure, Autism Speaks, McKenzie Monks Foundation, and the Partnership for a Drug-Free America.

Ken is the author of the best-selling books *The ABCs of Real Estate Investing*, *The Advanced Guide to Real Estate Investing*, and *The ABCs of Property Management*. He is also a contributor for *The Real Book of Real Estate* by Robert Kiyosaki as well as *Midas Touch* by Donald Trump and Robert Kiyosaki. Ken's fourth book, *The Sleeping Giant*, is dedicated to the new class of entrepreneurs that has emerged in today's economy.

Ken is an active member of the Young Presidents Organization (YPO) and the Entrepreneurs Organization (EO) holding several board positions including President. He has enjoyed inspiring people worldwide appearing and speaking for various programs and leading industry events and has also been featured on hundreds of syndicated radio and TV programs as well as speaking with and writing articles for many industry blogs.

Ken and his family reside in Scottsdale, Arizona and enjoy spending time with friends and family in Coeur d'Alene, Idaho whenever possible. Two of his favorite pastimes are coaching his children's sports activities and golfing.

Follow Ken online at:
www.KenMcElroy.com

For more information on MC Companies, please visit
www.mccompanies.com

VISIT
KM
KEN
MCELROY.COM



**YOUR INSIDE
SOURCE TO:**

KEN'S BLOG
FREE FORMS
INVESTMENT ADVICE
LATEST BOOKS
BUSINESS TIPS
EVENTS
& MORE!

KENMCELROY.COM



What Is KenFLIX?

KenFLIX captures Ken McElroy's decades of experience in short, educational videos. Topics range from basic property management, entrepreneurship, banking, financing, dealing with investor and raising capital.

What makes KenFLIX different from other sites, is his team. Ken takes us inside his company to the President of MC Companies, Director of Construction/Maintenance, his Controller and Investor relations manager. You'll also find videos from Kim Kiyosaki, the Rich Dad team and the Rich Dad Advisors.

Ken realized through years of receiving and being asked questions from readers and fans that he thought why just answer one person's question, when you can education many. Ken believes you should always be learning no matter what point you are at in the process. He wanted to share his knowledge with everyone.

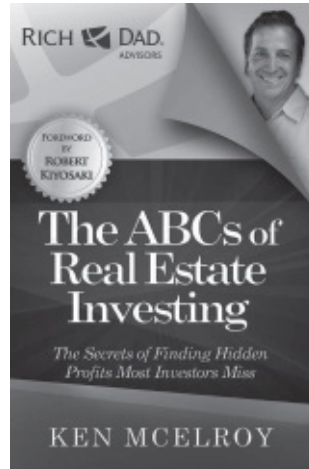
Your membership provides you access to all the videos—and there 8 new ones uploaded each month. There's also a discussion Forum and an "Ask ken@kenflix.com" where you can submit your ideas for new videos.

To learn more about Ken and KenFLIX go to www.kenflix.com

Join today!



Other Great Books by Ken McElroy



The ABCs of Real Estate Investing

In precise and entertaining chapters—each culminating with very specific Action Steps for readers to follow author Ken McElroy offers real estate investing stories from the trenches as well as his wisdom.

Chapters include:

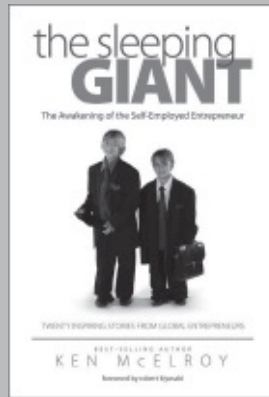
- **It Takes a Team**

Understanding that it takes a team to be successful in real estate. Determining whether you want a partner and evaluating partner candidates • **Is It Really a Diamond?**

It's as simple as this: In good deals the numbers work; in bad deals, they don't. You can't afford to ignore that simple truth. Learn why: the seller's asking price is irrelevant, why the property value becomes your offer, and why it always comes down to cash flow.

- **Swamp Land For Sale**

Selecting one market (and preferably one close to home) and staying away from gut feelings • **You Own It...Now What?**



The Sleeping Giant

The Sleeping Giant brings together 20 entrepreneurs who share their powerful and inspiring stories of how they found success through entrepreneurship. This book and its success led Ken to embark on another journey where he held a nationwide contest via Facebook asking people, “Are You The Next Million Dollar Entrepreneur?”

By submitting their ideas and passions for their businesses, one lucky person received \$5,000 toward their venture and a year-long mentoring program with Ken and many other highly successful individuals.



Advanced Guide to Real Estate Investing

You may have noticed the lack of coverage real estate investing gets in mainstream financial media, while stocks, bonds, and mutual funds are consistently touted as the safest and most profitable ways to invest. Real estate investment is something you can do on your own—without a large amount of money up front. Ken reveals the next essential lessons and information that no serious investor can afford to miss. Building

on the foundation of *The ABCs of Real Estate Investing*, Ken tells readers:

Chapters include:

- **How to identify and close expert deals**
- **Why multifamily housing is the best real estate investment**
- **How to surround yourself with a team that will help maximize your money and your success**
- **How to avoid paying thousands in taxes by structuring property sales wisely**

Notes