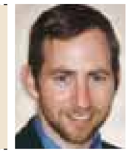

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Nip the Flip

Should mortgage brokers and originators discourage fix-and-flips?

For years, myriad homebuyers have tried to make fortunes by fixing and flipping homes. In reality, however, very few people are successful with the fix-and-flip model, as there are numerous conditions that must be ideal for a fix-and-flip investment to be worthwhile.

For instance, the home's purchase price must leave ample room for rehab costs, and the rehab estimates must be accurate. Further, the home's final sales price must be close to the buyer's original estimate, and the property must be sold quickly enough to allow the flipper to move homes and proceed to the next deal. Bearing in mind these factors, mortgage brokers and originators should advise their clients that there's significant risk in flipping a house.

In lieu of the fix-and-flip model, brokers and originators increasingly are suggesting that their clients take a different approach: what one might call the fix-and-hold approach. Under this model, investors buy a property, rehab it and then rent the property, ultimately either selling it or simply holding it in their portfolios.

Clients should know that this model is considerably less risky than the fix-and-flip model. For instance, with the fix-and-hold model, investors aren't pressed to flip their properties as quickly as possible; instead, they have the ability to wait for market downturns to pass and still make financial returns from their rental income.

That said, the fix-and-hold model works on the assumption that investors can obtain longer-term financing on their properties. Brokers and originators, therefore, should seek out lenders that write loans between one year and five years, as opposed to a traditional hard-money lender that writes a loan between 90 days and one year. This increased financing time gives investors breathing room to stabilize the property and then either sell it or take out a more conventional loan.

Risks versus returns in the fix-and-flip model

The first scenario assumes that all conditions align and that the buyer was accurate on all items. The second scenario assumes that the property's rehab costs are $15,000 higher than predicted.

Scenario one: 90 days	
Purchase price:	$80,000
Rehab costs:	$20,000
Prorated tax/insurance:	$438, assuming taxes of $900/year and insurance of $850/year
Basis in property:	$100,438
Sales price:	$125,000
Less Realtor commission:	$6,250 (5%)
Net income:	$18,313
Rate of return:	23%

Scenario two: Four months	
Purchase price:	$80,000
Rehab costs:	$35,000
Prorated tax/insurance:	$438, assuming taxes of $900/year and insurance of $850/year
Basis in property:	$115,438
Sales price:	$125,000
Less Realtor commission:	$6,250 (5%)
Net income:	$3,313
Rate of return:	4%

A risky investment

In considering the fix-and-hold model, it's useful to take a closer look at the fix-and-flip model — examining the intricacies of why this kind of investment can be so risky. Many borrowers still believe that the fix-and-flip model is a good one, so brokers and originators may want to delineate the reasons why it's becoming increasingly difficult to succeed in this endeavor.

As stated earlier, there are a number of conditions that must be ideal in order for the fix-and-flip model to succeed. To complicate matters, each of these conditions continues to evolve due to economic factors.

For instance, housing prices are rising as more novices enter the market under the assumption that they can make a fast return on their investments. Along with increased bidding at auctions, many markets are seeing a decreased supply of foreclosed homes, another factor that can lead to higher prices at the initial auction.

Further, in many markets, foreclosed homes are turning up at auctions in rougher shape, making it more difficult for investors to accurately estimate their rehab costs. An auction typically allows prospective buyers

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to do exterior inspections of the property, but it's still rare for buyers to be able to perform interior inspections prior to the sale itself.

Some markets also are still experiencing considerable downward pressure on prices. Arguably, it's still a buyer's market in many locations throughout the country. This results in many buyers being interested in a property only if they can get an exceptionally good deal — a circumstance that may be more difficult to achieve than many borrowers realize.

Finally, becuase of tighter underwriting guidelines from lenders, a sale's average closing time has increased in many markets. These new underwriting guidelines also have decreased the eligible pool of borrowers — another condition that seriously undermines the profitability of the fix-and-flip model.

Two examples

Consider the following example scenarios in order to illustrate the change in return on a fix-and-flip investment based on a change in the factors detailed above. A seemingly minor difference can result in a drastic difference in return. The following scenarios make no assumptions for financing costs and assume that the buyer purchases the properties with cash.

The first scenario assumes that all conditions align and that the buyer was accurate on all items. In this case, the rate of return would be approximately 23 percent.

The second scenario assumes that the property's rehab costs are $15,000 higher than predicted. This is a common problem that can be caused by a variety of factors, including the need for a new roof, plumbing issues, electrical problems and so forth. In this scenario, the rate of return would be just 4 percent, a fairly low return given the risk, time and effort involved.

These two scenarios are relatively common in the fix-and-flip model. One major risk factor that's difficult to calculate, however, is the span of time involved in a given situation.

Take scenario two, for instance, and assume that the additional repairs take several added months to complete. If the buyer needed funding for another fix-and-flip transaction, that buyer may be forced to drop the initial property's price by as much as 5 percent. This action, however, would drop the return on the property down to -3 percent. Needless to say, the loss of 3 percent would not be worth the risk assumed for the investment.

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Although the fix-and-flip model can be lucrative, borrowers need to understand that current economic conditions are causing the risk of such an investment to increase while returns simultaneously are decreasing. In contrast, the fix-and-hold model is not as time sensitive — assuming that housing prices eventually will increase.

With that in mind, brokers and originators should educate their borrowers about the fix-and-hold model, which, in turn, can allow buyers to take advantage of future price appreciation while also minimizing their risk. ●