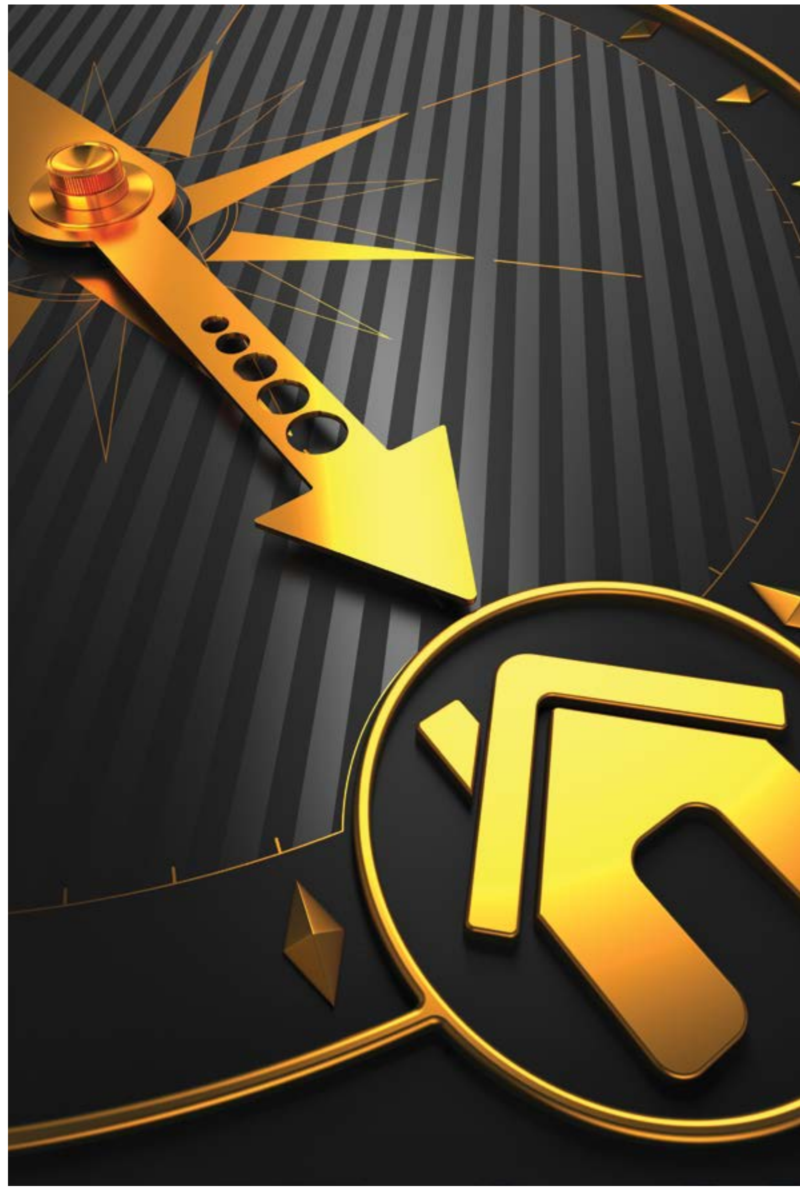
THE PROS AND CONS OF BUILDING A PORTFOLIO OUT OF HIGHER END PROPERTIES

BY JAMES KNULL

MANY INVESTORS OFTEN ASK WHETHER THEY SHOULD FOCUS THEIR PORTFOLIO ON HIGHER OR LOWER END PROPERTIES. In fact, I often get asked this very question during my first meeting with most novice investors. The question doesn't have a definitive answer because there are pros and cons associated with each that work for some and not for others. Understanding the benefits and drawbacks of each option will make it easier to build a portfolio that's a good fit for your personal investment style.



First things first, we need to define that high to low end so that the rest of the discussion makes sense. Of the available categories for rating property, condition and location make the most sense when determining how high or low end a property is. The condition is essentially the state of repair and age of components of the property. Location is a little more complex because the REIN Property Goldmine Scorecard teaches us to be keenly aware of future potential in a neighborhood. However, for the sake of this discussion, I'm going to only look at the quality of the neighborhood and its tenant profile at the current moment at the time of analysis because this is going to tie in directly to the current tenant profile. Finally, we're also going to assume that the properties are unfurnished to keep things constant.

By looking at how these pros and cons will impact you as the investor, we'll look at the some of the major factors impacted by a property being higher or lower end.

1. Tenant Turnover

Tenant turnover is one of the most time consuming and expensive events that will happen to you and your property. With almost every turnover there is some degree of maintenance to be done and often doing so will render the property vacant for at least a month. Furthermore, if your standards for a tenant are quite high, then you might have a multi-month vacancy period to subsidize.

Higher end properties typically attract better tenants because more people want to rent a nicer place and your selection is better. However, at the highest end of the price scale, the likelihood of a tenant having upward mobility is increased. In other words, you are appealing to someone who is renting in the short term and waiting to purchase their own home. While the turnover from this kind of tenant often requires fewer repairs, replacing them might happen more often. At the lower end of the spectrum, vacancies typically last longer because while there will be lots of interest from potential tenants, the percentage of these tenants being good quality is much lower. In other words, there will be lots of applications, but fewer will be qualified. Poorly qualified tenants at the lower end of the price scale are more likely to abandon the property or give insufficient notice resulting in extra months of vacancy. For this reason, good tenant screening becomes paramount. The positive here is that on the lower side of the mid-range, there are a much higher percentage of lifelong tenants. Lifelong tenants mean no turnover costs.

The ultimate goal is to minimize tenant turnover and to reduce the cost associated with the event. By understanding the type of tenant at each end of the spectrum, you can focus your efforts on filling the vacancy with the longest-term tenant possible.

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2. Potential for Return on Investment (ROI)

The two main areas of ROI are cashflow and potential upside. Potential upside comes from the ability to add value to a property by making physical improvements/renovations to the property. The better the condition of the property, the less value you can add to it. Therefore, if you want to see value added to the property above and beyond normal market appreciation, there needs to be some room for improvement. Lower end properties have the most room for improvement and therefore the most value upside.

As a general rule of thumb, lower end properties are less expensive. As a function of the lower purchase price, the lower mortgage payment yields higher cash flow on paper. There are many factors in play that result in a difference between "expected" cashflow and "actual" cashflow. For example, in a newer property, the lower "actual" maintenance costs might be lower than budgeted and produce a higher "actual" cashflow than the projected. An inexperienced landlord may very well incur higher vacancy costs due to choosing a poor tenant in a lower end property. However, both of these risks can be mitigated by experienced, high quality property management. As a general rule of thumb, lower end properties will show higher cashflow but the time and expertise required to realize it is also higher.

3. Stabilization Period

The stabilization period is the timeframe between closing on a property and having the property in a good estate of repair with established stable tenants.

With a higher end property there is little to no maintenance required. If it is new, often it will even come with a warranty. Place good tenants and you've got it stabilized. Lower end properties, on the other hand, may have a long list of minor repairs that will pop up during the first year. Often there will also be several items of deferred maintenance on the mechanical components. Furthermore, fixing all of these issues may require an initial vacancy. Overall, the stabilization period of a lower end property will be much longer and much more costly, something you will need to plan for. However, there is opportunity here again to add value to the property through improving it. Doing so requires time and expertise.

Conclusion

A lower end property has more potential to add value and more potential for cashflow. However, realizing this potential requires more time and more expertise. These factors can be translated into risk because making an error or taking more time costs money. Therefore, investing in a lower end property can be seen as a having higher relative risk and higher potential for reward. Some of the great examples of massive returns in short periods of time have come from improving lower end properties.

A higher end property on the other hand has little value to add and requires significantly less time and expertise to execute. These properties are typically best for novice investors or those who are interested in a more "turnkey" style of investing. While the returns are relatively lower, many exceptional investors have made great money focusing exclusively on these types of properties.

As an investor, there's no right answer of whether or not higher end or lower end properties are better. It's a matter of understanding what the implications of each are and choosing a strategy that fits your goals the best.

James Knull started his career in Real Estate investing in suited houses using the REIN system as his roadmap and continues to build his portfolio today. James now invests in Multifamily, is a REIN Diamond member and was awarded Player of the Year in 2014. James' passion for investing led him to become a Realtor in Edmonton. He specializes in investor clients and has worked for REIN members from BC all the way to Quebec to buy all kinds of properties in Edmonton. Contact him at james@jamesknull.com.