Buy and Hold Fund Continues to Evolve and Get Better

You may be wondering why the investment flyer included in your monthly newsletter looks different. Many of you in the small business world will not be surprised to hear that the the buy and hold model continues to evolve, always for the better, and the new flyer reflects this.

As I was thinking about the word "evolution," a funny personal story came to mind. Sixteen years ago, when my kids ranged from 3 to 10 years old, I was trying to explain the theory of evolution to them. We were on vacation, sitting at a restaurant in Sydney, Australia, enjoying a family meal. I probably took a good 10 minutes to explain the entire process of how humans evolved over time to look how we do now. At the end, there was a pensive silence at the table while all 4 of my kids thought this over. Tate, who was 6 at the time, was the first to look up with confusion in his eyes and solemnly say, <u>**"But Dad, I don't remember being a monkey!"**</u>

Unlike 6-year-old Tate's confusion on evolution, I know the evolution of the fund will not be confusing to you at all.

The type of homes we buy hasn't changed...

...but how we buy the properties and what we do with them has. We started out by only purchasing vacant homes. We would put them up for sale and then search for families that wanted to become homeowners to buy them. Once that deal was all put together, the fund would carry the mortgage.

Today, many of the homes we buy already have a tenant in them. <u>Ultimately, we still want to sell the home and become the bank and not the landlord, but we are okay with that happening over time.</u> We make the tenants aware they have the option to purchase the home and that we'll help them to do so by carrying the mortgage, if they qualify. However, not all renters are cut out to be homeowners, and that's okay too. We are good with them renting as long as they want if they are good tenants.

Why is this a better model? Two words: Cash Flow.

We have far fewer vacant homes. We are able to buy the same type of affordable housing in the core rental market but <u>**have them producing cash flow immediately.**</u>

Plus, we are finding better buys this way.

A better buy is not based on price but based on value. Value is the most important factor with anything you purchase. We all know that just because you can get something really cheap doesn't make it the best value. We have learned some of that the hard way by purchasing homes in bulk packages for really cheap prices. Cheap prices don't always translate into good value.

The real value with this model is that we are able to consistently purchase homes with rent priced below the current rental market rates. This primarily happens because the previous landlord was lazy about keeping up on the repairs, maintenance, and aesthetics of the home and therefore couldn't get the full market rent. By doing some of this work on the home (which is all done before the home is sold to the fund), we can raise the rent appropriately, have a little nicer place for the tenant to live, and hopefully attract a higher quality tenant.

The inefficient market is another advantage for investors.

When you buy in an inefficient market like these houses are in, it is much harder to know the exact value of the home. At first this may not seem like a good thing, but it actually works greatly to our benefit as investors. Where others will sometimes get caught up on how the home is priced, we work backwards by pricing it on the cash flow and the net return the property will produce. This approach works for pricing any income producing real estate such as apartments, multi-family, and commercial properties. It is based on cash flow and an acceptable net return for the investment. For those of you familiar with this practice, think “cap rate.” It is essentially the same measurement.

As fund managers, we follow a strict underwriting procedure…

….each and every time we purchase a home, or else we pay the price for getting sloppy. I like sloppy in my Joes but not in my investing (get it?). Sorry, bad humor.

A lot of research and knowledge goes into how we buy. We work backwards when underwriting any kind of asset purchase. What do I mean by “work backwards?” We always start with the investor in mind. Not because we are angels sent from heaven, but because <u>we know that the net return has to be attractive enough to get investors to participate</u> and for us to get paid for doing all the work.

How do we get a 9% to 12% net return for our investors?

We use a matrix when buying that requires an 11% to 12% net return per property. That net return is based off of the actual or expected rent ratio, depending on the property. (Rent ratio is the rent divided by the home’s price. $560 rent / $37,000 home price = 1.51 rent ratio.) Before we can calculate the correct rent ratio, there are many factors that must be used within our calculation. Here is a quick list:

- Vacancy Rate
- Carrying Costs
- Repairs and Maintenance
- Owner’s Insurance
- Property Taxes
- Sewer
- Any Utilities
- Special Assessments
- Property Management Fees
- Debt
- Depreciation

Then there are all the costs to buy the homes, manage the homes, manage the property managers, supervise the rehab projects, manage the repairs and maintenance, pay the mountains of bills on all these homes on time, collect the rent, track the rent, etc. You get the picture.

The reason why we calculate our matrix at the higher net returns of 11% to 12% is because there will be some dilution to our net return depending on the amount of cash the fund is holding in the bank. **Idle cash dilutes the return because it is not making any money while it sits in the bank account doing nothing.** Normally, idle cash is not a large percentage of the total assets, but it does play a factor in the overall return.

The fund never takes any of the risk up front on the purchase.

Since day one, Steve and I have always assumed all the risk by initially purchasing the properties through another company we own. We purchase the homes, have them rehabbed when needed, rent them out, and then, and only then, sell them to the fund.

We provide a 6-month warranty to the fund to guarantee the rent and any rehab that has been performed. The warranty assures that the fund is well taken care of and that we work hard to get good renters and quality work completed on the homes. Now you know why the the fund flyer looks different. One of my favorite sayings in business and life is, “We reserve the right to get smarter.” That is why we work every day to get a little smarter and better, always looking for ways to create better opportunities for our family of investors.

Until next time,

Steve Sixberry Greg Hughes

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