Ep #46: Taking Equity off the Table...Knowing When to Sell

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Dr. David Phelps and Evan Harris

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You are listening to the *Dentist Freedom Blueprint* podcast, with David Phelps and Evan Harris. Navigating you through the uncharted waters of a turbulent economy with straight-forward advice to, transform your practice into a self-sufficient cash machine, compound your net worth assets, and multiply, multiply, multiply your passive cash flow streams.

David: Hey everyone, this is Dr. David Phelps with my good friend Mr. Evan Harris. Evan, how are you doing today sir?

Evan: I'm doing real well David, thank you very much, and yourself?

David: Excellent, excellent. Hey Evan I've got a question from one of my Freedom Founders members, a dentist actually out of the east coast, Pennsylvania area. He's been in our group for a year or more and he's been doing some great investments through the group. He came across a very recent article, it actually came from John Mauldin, I don't know how many people follow John Mauldin, M-A-U-L-D-I-N, Thoughts From the Frontline. John's a great economist, if you're not following a good guy to follow. This article, the title was "The smart money is getting out of real estate." Of course my doctor member was like, "Hey David what do you think? Because you and I and the people we talk to, we're very, very bullish on real estate."

Not that we don't look at the markets and look at how we're investing but overall we're bullish. This doctor had a great question, he said, "What do you think?" Because this article talked about Sam Zell. If people don't know who Sam Zell is, Z-E-L-L, you can Google him. He's a real estate magnate. He's one of those people that runs private equity and hedge funds. They were talking about the fact that Sam Zell back in 2007, February 2007, that was ahead of that last downturn, that he sold his real estate firm called Equity Office to the Blackstone

Group, the big private equity, probably the biggest one out there. He sold it at the peak of the market in February 2007 before the real estate market crashed and financial markets crashed in 2008.

They say that Sam Zell's doing it again, right now, we're towards the end of the year 2015. They're saying he's doing it again. He's selling out a large part of his portfolio to some other buyers, equity funds. The question on this article Evan is, if Sam Zell's doing it should we be doing it too if we're also real estate investors? Where do we stand in this game? Are we foolish to stay in or are we missing something here? What's going to happen? I thought it was a great question because it should be going through the minds of people that are savvy and know that the markets do cycle, we know that they will. I gave him an answer but let me before I give my answer, Evan, what are some your thoughts on that? Let me go to you first.

Evan: Sure. I think it's a fair question. I think that we always want to look at mentors, we want to look at where big money is going. I find that there's often times a reason why big money is moving. It's not always the reason of the economy at large or a certain sector. They may have other goals in mind. They also may invest, when someone says real estate in my experience real estate is a pretty large umbrella. There's a lot that goes into real estate, are we talking about commercial? What type of commercial are we talking about? Are we talking about residential? Are we talking about apartments? Are we talking about certain states? We've got Detroit or we're got the Bay Area, there's so many different types of sectors. There's also personal goals, are they divesting of one thing so they can invest in something else? I think it's a great question, what are they doing? I would ask another question that I find even more valuable, I'd ask the why. I understand what they're doing, I can see that there's a liquidity event but my question would be why? Why did they sell? My last question would be where? Where are they putting it? That to me gives me a better idea of the reason for the move. I can also extrapolate what would that mean to me.

David: Those are great points. I think what you said really hit the nail on the head Evan, it's why. There are good reasons in any market why somebody would want to take what we call equity off the table. That could be equity in real estate, it could be equity in a business, because there may be other opportunities, as you said, that they have to move that money into. I'll also say that large hedge fund or private equity firms are managing a lot of other people's money, I mean a lot. The more money that's under management, really the trickier it is, the harder it is to maintain the financial responsibility to your shareholders, to your investing members, to try to get them the adequate returns in the market but do so safely.

I think in the kind of asset classes that a Sam Zell is going to be invested in, which are going to obviously larger commercial projects, there is more of a tipping point in my opinion, in what I see in my experience, to those larger projects. They can certainly go up when the market's going up, they can produce good cash flow dividends during the holding period, but someone like Sam Zell, I think he is a smart guy and he's probably looking at some of the different markets he's invested in. I don't know exactly what major metropolitan area he is in, and he probably has his finger on the pulse and he's going, "You know for my shareholders, the people that I am financial responsible to, this probably would be a good thing to do, is to take our equity off the table and go to cash and then maybe wait and see if and when there is a reset and then go back in the market."

He's just being I think very smart about it and not getting into a point where the markets do drop 20% or maybe more in some arenas, and then he's got to come back to his shareholders and say, "Gosh, I made a mistake." Are we in a bit of a bubble again Evan? I think you said it well, that real estate is very localized. It's very localized and there's certainly markets that took a big hit in 2008, 2009 and 2010 but have also bounced back up. They're the more volatile markets. Some of the commercial arenas that Sam Zell has been involved in, he probably came in and bought low, smart man that he is. He's ridden these assets classes back up again here now into late 2015 and knows that there's a good chance in the next 6, 12, 18 months, who knows, that there's going to be a reset. I think he's just playing it smart. Do you agree?

Evan: I do. I personally had an experience with that as well when we saw the market shifting in 05, 06. We saw that the prices that we thought were unsustainable, we did sell, but we only sold the properties that we were working on appreciation. There was some that we were holding on to because we knew they were becoming worth more. We had a duplex in an area that was being developed. It was really a lower income area and it was being converted with this enormous strip mall that was being put in. It was really becoming improved, it made the house worth a whole lot more but it was an area that we weren't getting a ton of cash flow on the rent. Once we thought the market was going to go down, we sold out, but what we kept were the properties that were cash flowing really well on the rents because we find that they can often times be inversely related, where just because real estate went down doesn't necessarily mean that the rents go down.

Even though we held on to the properties through that dip, our cash flow actually went up when the market shifted for us. We found a lot of people lost their homes, they were displaced. They were paying more for rent, they didn't want to go and rent an apartment just because they lost their house. They wanted to go from house to house. Maybe large house to medium house or medium to small house, but in my experience who I rented to often times were people who shorts led or got foreclosed on and they didn't really want to admit to their friends and family that their house, they just said they're moving and no one really knew whether they were renting or owning but they certainly weren't going to go into an apartment as that was considered a major downgrade. We saw rents increase quite a bit. Now property values are actually exceeding where they once were, but I'm very thankful that I did sell the properties that weren't being held for cash flow purposes because we were able to capture the upside and be able to reinvest in other places once the market returned.

David: Yeah Evan that's a great point. I call that geographic arbitrage. You're so right that when you are fortunate enough to buy into a market at a lower price point, and as you said ride both the increasing rents, the cash flow up as the market goes up, and the equity increase, there does come a time when the price increase, the value, the equity spread that you now have in that property is greater relative to the rent and you're right, there could be a point where it [says 00:09:18], "You know what? Let's harvest this equity from this marketplace and go into another market where we can go back and get a better ratio of value to rent, or rent to value ratio."

That's something that we do a lot in Freedom Founders when certain markets go up to a certain point, the equity is there and people don't know it but there's an opportunity to do what's called a 1031 tax free exchange where rather than having to outright sell a property that has great equity in it and then have to pay the tax on the capital gain, one can do a 1031 exchange and actually transfer the equity from one property sale to another property or properties, it can go into multiple properties. You can make that arbitrage play without incurring the tax, which is huge. It's a huge play. I'll bet that that's part of Sam Zell's, his program here. I'll bet he is seeing markets where he is ridden the equity play up and he's thinking, "Okay, now is a great time to harvest. Let's come back in and ..." It didn't say he's just going to cash. The article didn't say that he's holding the cash. Knowing Sam Zell, he's smart enough, he can probably go into other markets where he knows that rent to value play is better. He'll go there and increase his overall return on his cash investments for his investors and do better.

Evan: Yeah. I typically somebody if they're considering getting out, I would ask them the question, would they buy that property today if they knew the cash flow, if they knew the maintenance required, if they knew any kind of upsides. They did kind of a Ben Franklin balance sheet, the pros and the cons. What are the upsides, what are the downsides? If anything they'd make the best financial decision now because they know the property, there's no unknowns. Let's say they've held it for a number of years, would they buy it today given all of those values? If they were to say yes they would, then I would absolutely say, "Move forward then hold it." If they wouldn't, and they factored in the tax ramifications or the efforts of a 1031 exchange and they knew what they would exchange, then maybe they should let it go, but I'd always take in consideration what are their goals.

Not just purely a numerical cash number but what are their goals? Are they trying to set themselves up for financial freedom passively? Are they trying to control a certain area? Are they waiting for a certain development? I know people who held land and that was a sketchy time to be holding land in the downturn because all they had was taxes and weed abatement. They had only expanses and no income at all. Did they hold or did they not? Did they think that houses were going to be built on that land in the future? Now it looks like houses, actually multi-families are going in on that land and their land is worth quite a bit more, but that was ... Let's see it was from 2008 until now, that's close, that's 7, 8 years of holding.

They really had to ask themselves how much opportunity cost would they be losing by holding that. Only they can answer that question, but I would encourage anybody to ask themselves that question. Just get real, not emotional. Maybe they can dust themselves off if they sell something at a loss, they moved on. Or, maybe they sold early and it went up but they did the best they could with the knowledge that they had before them.

David: Excellent points. Evan I'm like you, I'm primarily a single family guy. I haven't been involved in some commercial properties and projects. In fact this year I had 3 commercial properties, all of which produced good cash flow but kind of like Sam Zell, maybe not for exactly the same reasons because of my in area we don't have high volatility. Our values go up and down very, very, very modestly in up-markets and down-markets, but I still felt like because I like single family, and I'll tell you why in just a minute, better than commercial, I went ahead and sold those 3 commercial properties and actually did 1031 exchanges into some single family assets.

The reason why I like single family is that only is there the investment component like there is in virtually any other real estate but there's also the value that owner occupants, home owners, not investors but home owners put on single family. Single family properties have always been, and I think always will be in the future, the easiest kind of real estate to finance. Now not always so easy for investors but for home owners because real estate home ownership has always been the American dream. The ability for home owners to acquire homes with institutional financing, it's always been relatively easy in this country with 30 years fixed mortgages, it always makes single family houses I think a very safe play for investors who are not experts in the real estate arena. That's typically what I tell doctors and dentists. I say, "Look, start with something that is really easy to evaluate and buy it first and foremost on the cash flow, the cash flow relative to value." If you buy it for cash flow, as you said Evan, even when property values go down in market reset the rents typically don't follow.

The rents will maybe stabilize for a year or 2 as they did for me back in 2008, 2009 and 2010, but from about 2010 on, through this year, they've been going up and up and up. Values have been going somewhat in my area as but that's the cash flow I buy for. If you look at the cash flow and you're really an investor and not a speculator then you're going to be fine if you're investing in good solid real estate, good solid single-family assets in markets that don't have a lot of high volatility, where you're not speculating, you're not playing, "Well I think the prices will go higher and higher," and then whoops of all of a sudden you get caught at the top of the market, maybe highly leveraged, which is not what we recommend, but if you stay, play it safe and go with the cash flow play I in 25 years have not suffered any major calamity. Nothing that's taken me down. That's why I tell my docs, I say, "Don't be afraid, the markets will always change. We just have to learn how to surf the waves so to speak and not get plowed under like many people often do."

Evan: Yes. I had mentor that used to always say, "Evan, make sure you make money at the time you buy." It was always a hard concept for me to understand. What do you mean make money at the time I buy? If anything I'm not making any money, I'm putting money out. The answer many times is make sure that the cash flow already expected more than meets your expectations on your investment. Let's say I have a debt service, 1,000 a month and the rental income minus expenses are going to be 1,500 a month, that day that I bought that property is going to be $500 a month cash flow instantly. I'm already in the positive the moment it's purchased. Sure things can pop up or are already giving a number to the expenses. We already know what the taxes are going to be. We already know what the rate of occupancy is going to be. We're going to mitigate those risks and build in for those. I would imagine we'd need a new roof possibly every 20 years, but we build those things in and know that the moment of purchase we're winning the moment that happens.

Even planning in for economic movement. When I study movement economically, movements can go really fast, often times on the security side, but when I study real estate, it's not the same. It moves over periods of months, if not years. The trend is not a spike and drops. Yes if I look over 12 months, 24 months, 48 months, sure it can look like a roller coaster, but often times it doesn't look anywhere near like stocks because it doesn't have the efficiency. I can't just go on my brokerage site and buy some shares or sell some shares. It's not a liquid asset and because of that markets tend to respond in a slower movement which has been great for us, so that we can be able to make moves ahead of time. When there is movement, plus or minus, it's usually quite slow and we had the indicators well ahead of time. If people are well connected with mentors and groups and masterminds like you put on David, they're going to smell it way early. It's rare that something happens that completely throws us for a loop.

David: Yeah that's so true. Let's finish this out by maybe talking about 1 or 2 examples of what each of us Evan is doing in our respective investing for both our own portfolios and maybe for some of the investors with us. I'll go first and let you finish up. People ask me, "David are you still buying? Are you still investing." I say, "Of course I am," but I'm using the same parameters that we just got through discussing Evan, I'm looking at cash flow. Because of connections that you and I find so beneficial and network of a community of different investors that we both know and we've built over the years, the ability to invest in different markets both in equities, that is maybe owning having interest, [either 00:18:40] holding interest in property through your LLC or also from a lending.

Lending is a great way to go where you can lend money a lot of times out of retirement accounts and lend money against property both short term or long term. Doing it in markets where there's a history of safety, where we don't have those high ups and downs and always looking at the cash flow that the property's producing whether you the property as an equity holder or you're a lender, you still always want to make sure that whoever it the holder of that property there's good cash flow on top the debt service and on top of the maintenance, the property taxes, the insurance.

As long as there's safety and it's a good economic area then you're going to be fine. You're going to be fine and you'll never be investing, or you shouldn't be investing100% to market value, which is something you can't do in the stock market. There is no discount; you pay whatever the market says the stock is worth that day. In real estate as you said Evan, it's localized, there is no [efficient 00:19:38] market place and you have the opportunity either yourself or through the people that you invest with to get in on wholesale opportunities. That's what makes real estate so attractive.

Evan: Yes, for us I would say that we're watching the market very closely. We're attending all of the different clubs and we have mentors, virtual mentors. Some I've never met but either listened to their podcast or read their updates. For us, we always operate under certain ratios. Right now we're on a more conservative ratio, we want to see plenty of equity in the deals. We're largely lending. We do acquire but our focus has been lending to people who are rehabbing properties and we [make 00:20:17] points in interest through that. We find with plenty of cushion that we're in a really strong position. Right now banks are still having a tough time lending.

That really opens up a big opportunity for us so we can be able to capture at premium on the money lent just because there's no one else able to really lend to people who need to buy cash. We can be able to lend in 5 to 10 days, sometimes even faster. We have these great relationships with our borrowers that we've known for many, many years. For us we mitigate as many risk as we can through relationships, through knowledge and also through having plenty of cushion in equity. We also look at cash flow too. If there a necessity to hold a property, what would it rent for? What would the exit strategy ... I like to have multiple exit strategies just in case something happens.

We could have a major change in our country, we could have the next president, who knows what could happen there? I'm open to those changes but I'm going to have multiple strategies and I want my money working at all times. I don't want to put it under the mattress, I don't want inflation eroding it and having nothing. I want to take intelligent risks and have intelligent gains that come from that. David it looks like our time is up. I want to tell our listeners if you are listening to us on iTunes please let us. Please like us. Please leave us a review. Let us know what content you'd like to listen to. What do you want to hear more about? What's tough out there? What if you knew the answer to something, it would make it a lot better for you? We may not know the answer but we have a lot of people that do. We can reach out to them and find the answer for you. This has been Evan Harris and David Phelps, 2 men on a mission to help practicing professionals grow and have the lifestyle of their dreams.

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