Real estate principles: a value approach

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Get a free digital download guide for beginners to invest in real estate. Contact 1,000,000 real estate investors! Find local real estate meetings and events in your area. Start analyzing the property, we will do the math for you. I'll admit it. I'm a recovering engineer. To tell you the truth, I shouldn't have gone to engineering school. I didn't know myself at all. I did not know my strengths and weaknesses, my sympathies and dislikes. I didn't know that I was created to be an entrepreneur and certainly didn't know about the power of investing in real estate. So, in my junior year of high school, I learned that there were no degrees in parapsychology (yes, I hesitate to say I'm serious). I wanted to do something adventurous, and that's about the time I heard about oil engineering. So I signed up. It was my first big mistake in my career. But I don't have to complain. I enjoyed a rigorous education, and my (more valuable) MBA degree seemed easy in comparison (without calculus or physics!). And I learned important Buffettism before I ever heard of Warren Buffett. I hope you already know about it, in title or in practice, but if you don't practice it, you're sure to come to financial ruin. This is called a safety reserve. This post is the 7th in a series that Brian Taylor, John Jacobus and I affectionately call Warren Buffett my real estate mentor. We hope that Buffett's wisdom affects you as it has us. What is the security margin? A safety margin is an investment principle in which an investor buys assets only when their purchase price is well below their estimate of domestic value. In other words, when the purchase price of an asset is well below your estimate of its internal value, the difference lies in the margin of safety. Since investors can set a margin of safety in accordance with their own risk preferences, buying assets at this margin allows for investments with a lower risk of decline. That's what Investopedia says. Related: What Interview 100 Investors on Failure Taught Me About Losing Money That Sayeth Warren Buffett? Well, if you're driving a truck across the bridge that holds-it says it holds 10,000 pounds and you have a 9,800-pound car, you know if the bridge is about six inches above the slit that it covers, you may feel good. But if it's, you know, over the Grand Canyon, you may feel like you want a little more margin of safety, in terms of just driving a 4,000-pound truck, or something, across. So it depends on the nature of the main risk. - Berkshire Hathaway Annual Meeting 1997 Create an account today to get BiggerPocket the best blog articles delivered to your inbox Sign up for free It really remind me of an engineering school. When designing drilling rigs or bridges, we must Design all the components to counter all the forces that may be involved. When all the calculations were done, we had to slap on the safety margin or safety factor. If If The safety factor was 3.2, we had to make it 220% stronger than it needed to be. (This would mean a margin of safety of 2.2, but it becomes technical.) For 19-year-old punk, it seemed like an unnecessary waste of time. Please wait... The largest semi-truck allowed on this road weighs 80,000 pounds. But do we have to design a bridge to withstand 256,000 pounds? Isn't that a huge waste of time? (I didn't know that one of the four U.S. bridges failed in the 1800s.) Thirty-six years later, it makes a lot of sense. But then it didn't happen. I haven't thought about this engineering term when making an investment, but the widely read Buffett has connected the dots for me. Reserve strength is a key concept for us to understand when to make an investment in something that is inherently unknown. It's every investment I can think of. Strength reserve is a risk management concept that makes us think about our purchase price compared to our estimate of domestic value. Using non-financial examples like the Buffett Bridge really drives the point home for me. Having a margin of safety is an intuitive concept when deciding to cross a bridge (unless you're a daredevil), but it can be harder to see when studying, say, pro forma analysis of potential investments. So, what does this mean for real estate investors? Real estate has a lot of unknowns. Your floating debt can change based on unpredictable factors. Your local economy may suffer from layoffs. Your real estate manager can make bad decisions. Your turnaround plan may suffer from unforeseen commodity tariffs. The list can be sing. The challenge is not to focus on accurately calculating the margin of safety for all these unknowns. You just can't do it effectively. (Check out this previous article about becoming a billionaire by being about right on a few key variables.) The key to buying a property is at a price that allows for social protection in case some random combinations of these currently unknown events occur. Related: 3 Ways to Reduce Risk in Your Real Estate Portfolio Some practical examples of ensuring that your investment property has adequate debt servicing coverage (DSC) is a great example of why building in reserve strength is crucial. You need to make sure your cash flow is sufficient to cover your debt obligations. But should you just make sure it covers it just 100%? Or should you make sure that you cover debt servicing more than 100%? You know the answer. You don't want to risk some unknown phenomenon that will increase your operating expenses and leave you unable to pay your mortgage. This is a good way to learn a very difficult lesson in real estate. You will be glad to know that your banker will not allow this. insist on a margin of safety of at least 25% (debt servicing ratio of 1.25 times - you should aim for much higher than that). Another excellent example is the prediction of occupancy and rental rates for apartment buildings. You can easily find data that show average occupancy and rent for comparable properties. When you do, should you just use these averages for your forecasting purposes? No. When applying margin strength, you want to predict your occupancy below market averages and the same for rental rates. This is often described as conservative, but in fact you add a margin of safety in case your property suffers from low occupancy or your projected rental rates do not occur. Your investors will thank you, believe me. Why I'm not investing in multifamily right now as the author of an arrogantly entitled book about multifamiy investments, I'm often asked why I don't (or why I rarely) invest in multifamily right now. And why our company has expanded to self-preservation and mobile home parks. This is a fair question that deserves to be answered. My answer includes a margin of safety. As I said in several recent BiggerPockets posts, most anyone in the multi-faceted world knows prices are crazy overheated right now. Yet there are still many willing buyers seemingly wanting to overpay. I have a few theories as to why this is happening, and some astute commenters on my last post added a few more. This obviously continues to stimulate price growth. I hope you are not one of these overly zealous buyers, but if you are, I encourage you to stop it! My firm is still considering multi-family opportunities, but we believe that most of them will be on the other side of the market correction. Correction? When? This will require a crystal ball to predict. And those who live with a crystal ball are destined to eat ground glass. Buffett won't even predict the timing of these downturns. But he learned to act appropriately in every moment of the cycle. And that's what we have to do, too. I was at a big conference in Miami two weeks ago, and one of America's most famous multi-family syndicators defied my thinking. He has been incredibly successful during this nearly decade of price increases and he has earned the right to be heard. He said: Don't worry about overpaying for a family. Just find a great hotel in a great location. He went on to explain his reasons. (I don't call it because I don't catch the exact quote, and I don't want to make it look bad.) My friends, my mind drifted fast to Mr. Buffett, who has been massively successful since about a year since this guy was born. Through many recessions, wars and more, Buffett has amassed one of the most enviable fortunes in history. And he gave us his wisdom all the way. Will Warren Buffett ever say that? Will he say: Am I ok with consistently overpaying for the companies I buy? Not on your life. Buffett is clearly looking for companies that are undervalued, with hidden potential that has not yet been realized. Buffett had the courage to buy financial stocks when markets were in freefall in 2008. Buffett has consistently said no buying is at the top of the market. Buffett lives on the limit of security. It would be good for us to do the same. How about you? How do you you In the safety margin when investing in real estate? Comment below! 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