

WHY BUYING THE WORST HOUSE ON THE BEST STREET MIGHT NOT BE THE BEST IDEA

By Paul Do

One of the most well known sayings in real estate is: “buy the worst house on the best street.” What it really means is that a property’s location is more important than the physical characteristics of the property because you can’t change it. This is generally true, except for the owner-occupiers who might prefer to live in a mansion in the outer suburbs than in a shack near the CBD.

But what if we fix the location? Is buying the worst house on a street the best idea? In my experience, no. When it comes to the worst properties, investors see an opportunity to pick up a property for less than its true value, arguing that most buyers will avoid these properties because they require too much work to fix up. They also think that the worst properties provide the best opportunities to add value, further increasing their returns. Owner-occupiers see a blank canvas to put their own stamp on the property.

As a result, buyers tend to behave irrationally towards the worst properties. Instead of walking away when the price reaches fair value, they are prepared to pay more, thinking that they can more than recoup the additional outlay from the repairs and renovation. This irrational behaviour drives up the price of the worst properties, so that many are overpriced to start with, and you would make a loss on the buying stage with these properties.

To compound matters, it is very difficult to buy a run-down property and renovate it for a profit, despite the myth created by the renovation shows on TV. If it were easy, you would see many more tradespeople getting into the game either by themselves or in partnership with equity investors. When you take the opportunity and holding costs into account, and exclude the natural capital growth of the property, few people can confidently say they made money on the renovation stage.

Another reason is that the worst house on the street is also the cheapest, and has the most possible buyers. In contrast, the best house on the street, is the most expensive, and has the fewest possible buyers. The level of competition from other buyers is very important because my first buying criterion is to avoid competition. You can only bag a bargain by avoiding competition from other buyers. As a matter of fact, when I encounter too much buying competition, I usually increase my budget to move to a higher price point where there is much less competition.

Finally, the worst houses are never overcapitalised – where the owners have spent too much on the renovation/addition and are unable to recoup all of their outlay. On the other hand, it is much easier to find overcapitalised houses among the better ones, especially when markets are weak. Sometimes these start off being the worst house on the street that fell into the hands of a novice investor or owner occupier with grand renovation plans. It is much easier to wait for the novices to do all the work and then buy the overcapitalised properties.

If you insist on targeting the worst house on the street, then make sure you only need to make cosmetic, not structural changes, to the property. Structural renovations require major changes to the “bones” of the property, and are expensive and time consuming. They also require specialist knowledge and skills, and anything that can possibly go wrong with structural renovations, will go wrong. Cosmetic renovations, in contrast, only require giving the property a facelift or some added functionality to increase the rent.

Also, before you embark on any renovation project, get feedback from real estate agents and valuers on the needs of the market and the value you can add to the property, to avoid overcapitalising. This helps you work backwards to calculate your walk-away purchase price as the expected value of the house after renovation less all costs (including opportunity and holding costs) and profit margin.

In conclusion, buying the worst house on the street might not be the best idea because you could end up with an overpriced property to start with. Moreover, it is difficult to make a profit just on the

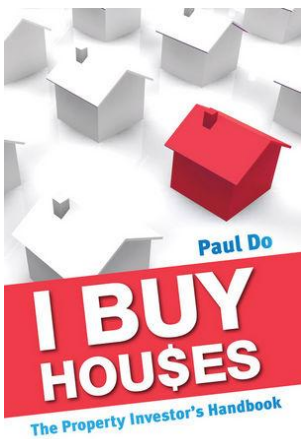
renovation stage, let alone to make up for the possible loss in the buying stage. My preference is to buy the better properties. There is less competition, and sometimes the properties are overcapitalised, which means that I get more property for my money.

Paul Do is the author of *I Buy Houses: The Property Investor's Handbook*. For more information go to www.ibhb.com.au.

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BOOK REVIEW

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|-----------|--|------------|------------------------------|
| Title: | <i>I buy houses: The Property Investor's Handbook</i> | Author: | Paul Do |
| ISBN: | 9781 7421 68494 | Publisher: | Wright books, Brisbane, 2009 |
| Reviewer: | Brian Cordiner | RRP: | \$34.95 |



Paul Do is a successful Australian investor in both the stock market and in real estate. This is his first book, developed over 10 years, and it reflects his practical experience in investing in real estate over different real estate cycles and in various Australian states. He has “been there - done that” with purchasing and selling established properties as well as acting as the developer when the situation warrants.

The book is suitable for first home buyers and also experienced real estate investors. There are five parts to the book covering: the real estate basics; his SYSTEM T decision making process; detailed information on the buying process; managing your properties and finally - the part of most interest to people with reasonable knowledge of real estate - making money in real estate.

The author provides a step-by-step guide to the buying process that he advocates and includes a live example of the decision making process applied to the purchase of a Sydney property in 2007, including how he selected the property to bid on, from the 10 potential candidates he identified in his research.

The buying process that Paul utilises involves a “value” approach to real estate investing with substantial desk research rather than numerous property inspections. He researches the real estate cycle using a top-down approach starting nationally, then by state, by city within the state and even down to the suburbs within the cities to find buying “windows” (or selling opportunities). He strongly recommends the accumulate strategy and only contemplates selling if it is absolutely necessary or to take profits to fund a new acquisition. If property prices are outside his “buying zone” he recommends waiting on the sidelines or investing in other assets until the cycle swings your way again.

Utilising graphical trends and applying his technical analysis to the real estate cycle, and having determined the intrinsic value of the property (from net present value of future cash flows), he finds the “buying zone” which may be a few months or years in duration. Features of the book include a comprehensive glossary, index and reference list as well as a listing of resources to assist the reader. He references his own website www.ibhb.com.au which is a useful resource for potential investors.

In summary, the author shares with us his substantial experience in selecting, purchasing and managing real estate investments and is a value read for any serious real estate investor.

Brian Cordiner is a member of the AIA.

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