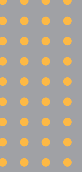

September 9, 2005

REAL ESTATE FLIPPING

Gold Mine, Mistake, or Fraud?

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In May 2004 I learned that the house across the street from mine, similar in size and features to my own, had been sold for $435,000 to a buyer I'll call Mr. X. He had made a down payment of approximately $87,000 and undertook a mortgage for $348,000.

As the months went by, the house was visited by a set of workers who did repairs and improvements. I awaited the arrival of the new owner, but Mr. X never moved in. Instead, having owned it for several months, he put it up for sale for $745,000. Since this price was about $100,000 higher than any comparable sale price on our block, I wondered if the house would sell, and indeed it remained unsold for three months during the excited market of early 2005. But in April, the house was sold to a buyer I'll call Mr. Z – for the asking price of $745,000!

In a sense, this sale raised the current value of my own home by about $100,000. But it was far more profitable to Mr. X. He had made a nominal profit of $310,000 after owning the house for eleven months. Estimating $50,000 in repairs and improvements, a $45,000 realtor commission, $20,000 for eleven months of mortgage payments on his $348,000 loan (having put down $87,000), $8,000 for property tax, and $3,000 for insurance, the remaining profit was $184,000, more than twice the original investment of $87,000. Even if the expenses had been $50,000 larger (for instance, $100,000 in repairs and improvements instead of $50,000) the remaining profit would be $134,000, again more than the original investment. Mr. X had done very well!

The Definition of Flipping

What happened across the street was neither unusual nor criminal. Flipping is ***not*** inherently fraudulent. It is true that fraudsters seek to make their illegitimate profits quickly and ***some*** flip sales are indeed frauds. But not ***all*** flippers are fraudsters.

- ***Fraudsters*** seek to make money through the use of ***false information.*** They may knowingly submit incorrect information on a loan application or use a "straw" buyer. Sometimes they conspire with dishonest appraisers or mortgage loan officers to inflate the price of a property offered for sale, or to get an otherwise unsupportable loan approved. In general, fraudsters knowingly use false information to cheat a buyer or lender.

- ***Flippers*** seek to make money by purchasing distressed or undervalued property, raising the value of a property through repairs and remodeling, or simply taking advantage of a hot and rising market.

Mr. X had engaged in ***flipping***. Most residential buyers purchase a home as a place to live for several years or longer. In contrast, flipping is distinct from normal residential buying by its short time horizon, usually less than two years and often far shorter. The buyer may or may not live in the home for a short while. The buyer may live near to the purchased property – or may reside in another state or country. The buyer may or may not rent out the home to gather additional income. The buyer may or may not make repairs and improvements – ranging from a simple "cosmetic" painting to a complete rebuilding of the home. The *distinctive* characteristic of flipping is the purchase of a home for quick resale, to make a substantial profit in a short time.

Some quick resales are not true for-profit flips. Some of them are foreclosed properties resold by a lender, often at a discount for a quick sale. Others represent lenders taking possession of properties on which the borrowers had defaulted after a short period of ownership. Some resales are done for tax purposes or for other legal reasons such as the transfer of ownership. Thus, there will be *some* quick resales in any type of market, rising or falling, which are not the sort of for-profit turnaround sales that are considered flips. However, for the purpose of this study, we will examine trends associated with ***all*** resales within the first 24 months after purchase with the understanding that we cannot know the intent of the purchaser.

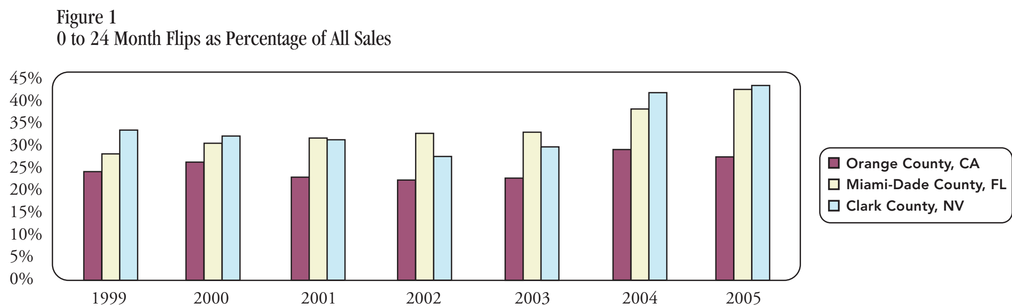
Flipping is a legitimate form of real estate investment. It is speculative in nature; great gains can be made in a short time, but great losses are also possible if a property cannot be sold at the desired price, which can happen if a market turns for the worse. Clearly, successful flippers need an environment of rising prices, since flipping makes no sense in a flat or falling market. Because of the costs of buying and selling, and the costs of holding the property, a flip sale will generally need 15 percent or more of appreciation to be worthwhile. Sometimes a property will be flipped over and over through a series of buyers who sell the residence as soon as they have acquired it. In this situation, all the flippers make money except the last one in the chain, who can be left holding a property he or she is unable to sell at the desired price.

In a highly heated market, some buyers engage in *pre-construction* purchase arrangements, often with the intention of selling at a profit shortly after the house or condominium project is built. An extreme form of such speculation involves selling one's purchase rights or reservation at a profit while the project is still unbuilt, as much as one or two years before completion is envisioned. In this way, a residence can be flipped at a profit before it exists at all. Such pre-construction flipping can realize substantial gains, but also has the potential for loss if a market weakens before construction is completed. This study will not examine pre-construction flips.

The Data Set

The present study looked at flip sales of residential properties sold from 1999 through June 2005 in three counties where the real estate market has been very strong: Orange County, California; Miami-Dade County, Florida; and Clark County, Nevada (which includes the city of Las Vegas). The data set began with the set of all residential properties sold in these three counties (whether flips or not). Special attention was given to flip sales, which were defined as having been held for two years or less. This group of sales was in turn divided into subsets based on the length of time the property was held. The most interesting flip set was those properties with three to six months' time elapsed between sales.

Figure 1 below shows the percentage of flip resales (two years or less since the previous sale) in the three markets.



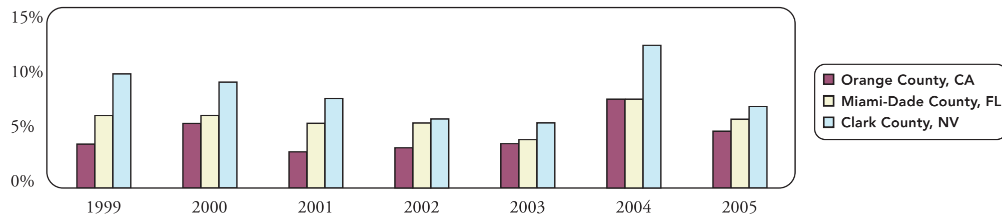
(Source for all graphs and tables: First American Real Estate Solutions)

From Figure 1 we see that each market had a *minimal* (what I may call the *ordinary*) percentage level of sales made after holding a residence for two years or less; about 20 percent in Orange County, California and 25 percent in Miami-Dade County, Florida and Clark County, Nevada. No one would say that those markets were dominated by flippers for the entire 6.5 years from 1999 to June 2005.

Figures 2 through 5 on the following pages show the percentages of flip sales separated according to the time span between the two sales: 0 to 3 months; 3 to 6 months; 6 to 12 months; and 12 to 24 months.

Percentages of Sales: Flips of 0 to 3 Months

Figure 2
0 to 3 Month Flips as Percentage of All Sales

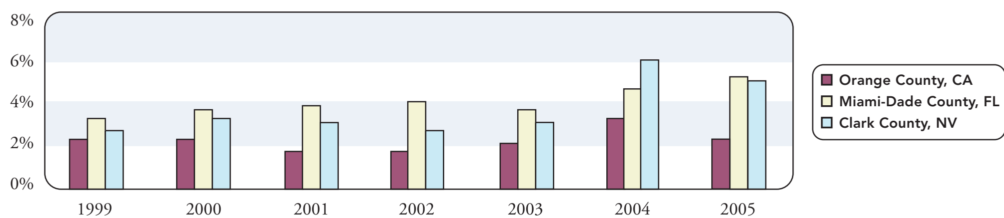


The information in Figure 2 (flips of 0 to 3 months) is inconsistent, showing an apparent decline in flips of that length, followed by a sharp rise in 2004 and a decline in 2005. The picture here is not clearly defined, as many events of this short duration are not actual market flips but transfers done for legal, tax, ownership recording or other purposes. Accordingly, the rest of the study will focus on flips of 3 to 24 months.

Percentages of Sales: Flips of 3 to 6 Months

Figure 3 below shows that flips of 3 to 6 months were most prevalent in Clark County, Nevada and Miami-Dade County, Florida, with Orange County, California being the least prone of the three to this type of flipping. In Clark County and Miami-Dade County this flipping intensified during the hottest years of 2004 and 2005. In Orange County, 2004 was the strongest year for flipping; 2004 was a year of faster price rises than 2005 in this county.

Figure 3
3 to 6 Month Flips as Percentage of All Sales

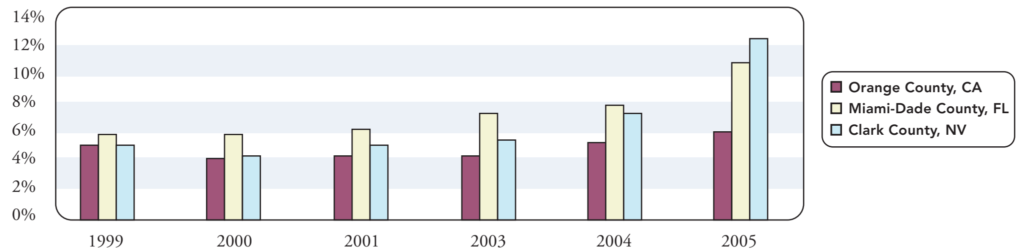


This time span represents the sweet spot, flipping of the purest type, in which a property is put back on the market immediately after ownership is acquired, perhaps with minor repairs or painting, but without an extended period of major remodeling. Such flips often occur in a hot market when properties can be quickly resold, frequently falling in the three-to-six month time range from sale recording date to sale recording date, including a typical 30-day escrow period.

Percentages of Sales: Flips of 6 to 12 Months

Figure 4 shows a dramatic rise in this type of flipping in Clark County and Miami-Dade County during 2004 and 2005.

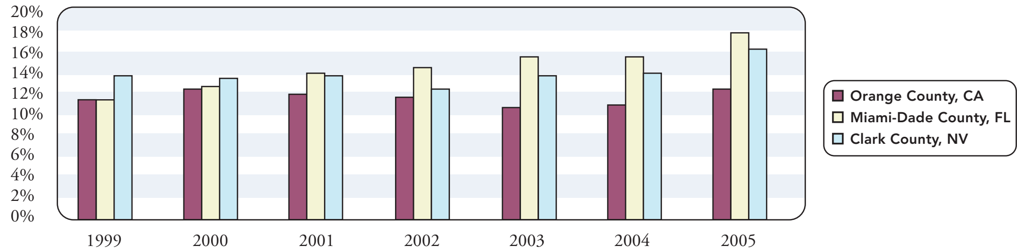
Figure 4
6 to 12 Month Flips as Percentage of All Sales



Percentages of Sales: Flips of 12 to 24 Months

Figure 5 shows an increase in flips after 1 to 2 years of ownership during the hottest market years, but this rise was not nearly as dramatic as for the shorter-term flips.

Figure 5
12 to 24 Month Flips as Percentage of All Sales



Do Flippers Make a Market – or Ride a Market?

Flippers ride the wave of a rising market and profit from it – but do they ***dominate*** or ***define*** a market? The answer depends on geographic size. At the ***county*** level, we have seen that flip sales did ***not*** dominate the overall markets as a percentage of total sales. In smaller ***local areas***, flip sales ***can*** dominate the market. Table 1 below shows the zip codes where the proportion of flips exceeded 40 percent for 2004 or 2005 (all in Miami or Las Vegas; none in Orange County).

Table 1
Flips as Percentages of All Sales, Selected ZIP Codes

ZIP CODE	CITY	YEAR	PctFlips 0-3 Mos	PctFlips 3-6 Mos	PctFlips 6-12 Mos	PctFlips 12-24 Mos	Total PctFlips 0-24 Mos
33127	MIAMI	2004	8.0%	6.5%	12.4%	14.9%	41.8%
33127	MIAMI	2005	10.8%	4.6%	14.1%	17.4%	46.9%
33142	MIAMI	2005	7.4%	8.3%	11.2%	15.5%	42.2%
33147	MIAMI	2005	7.2%	6.5%	11.6%	17.0%	42.4%
33150	MIAMI	2004	9.5%	8.4%	11.5%	12.3%	41.7%
33150	MIAMI	2005	5.1%	8.2%	13.2%	17.1%	43.6%
89119	LAS VEGAS	2005	14.5%	3.7%	24.6%	9.6%	52.3%
89147	LAS VEGAS	2005	3.7%	1.4%	32.3%	8.3%	45.7%

How Much Money Did Flippers Make?

Certainly, flipping grows in intensity and receives greatest attention when prices are rapidly rising. After all, if prices were flat or falling, why would people voluntarily flip properties at all? In particular, transaction and holding costs suggest that a flip sale should involve a price appreciation ***(gross profit)*** of at least 15 percent between acquisition and resale to generate a true net gain; resales with *lesser* profit are usually involuntary sales, failed flips, or sales done for other reasons such as legal, tax, or ownership-name-change purposes.

Under such circumstances, a flipper can do very well indeed. A flip sale for 15 percent ***gross profit*** after 3 to 6 months elapsed time represents roughly a 40 percent ***annualized*** appreciation rate (with a linear computation of appreciation, not compounding it continuously). In fact, the return on ***actual investment*** (down payment, holding costs, cost of repairs and improvements if any) may be far higher. If a buyer puts down $50,000 on a $500,000 property and sells it for $600,000 a few months later without making repairs or improvements, the flipper receives $150,000 (triple the original investment) before allowing for transaction costs and holding costs; even after allowing for such expenses it is easy for the flipper to double the original investment in less than half a year. In fact, if the flipper's down payment were smaller, the return on investment would be all the more.

We cannot know exactly how much a flip investor has spent beyond the down payment. But we can look at the price the flipper ***paid*** and the price the flipper ***received*** to calculate the ***gross profit,*** and adjust for the length of ownership to estimate an ***annualized appreciation rate.***

Profit Rates: 3 to 6 Month Flips

Figures 6 through 8 below look at gross profit and annualized appreciation rate for this type of flipping in all three counties during the full year of 2004, which was the hottest full year for flip sales. The profit range in Figure 8, for Clark County, extends farther to the right because the profits made there were especially high. The "implied break even" level of 15 percent ***gross profit*** appears as a vertical green line, dividing in half the bar which represents gross profit from 10 percent to 20 percent.

Figure 6
Gross and Annualized Profit, 3 to 6 Month Flips, Orange County, CA

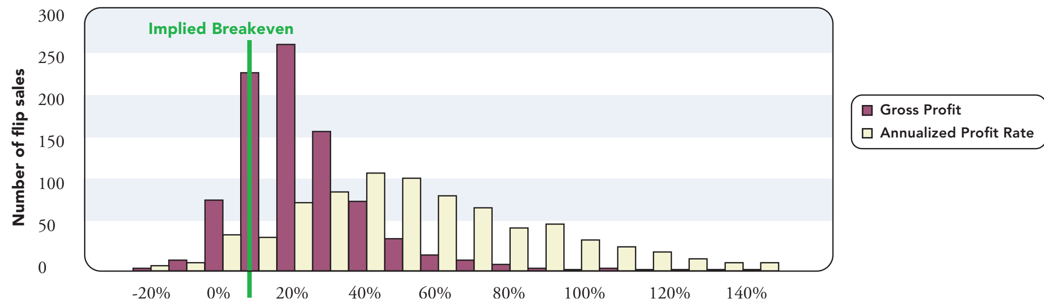


Figure 7
Gross and Annualized Profit, 3 to 6 Month Flips, Miami-Dade County, FL, 2004

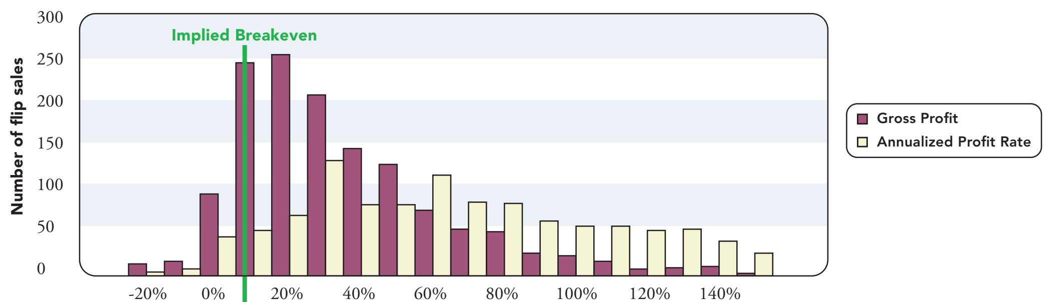
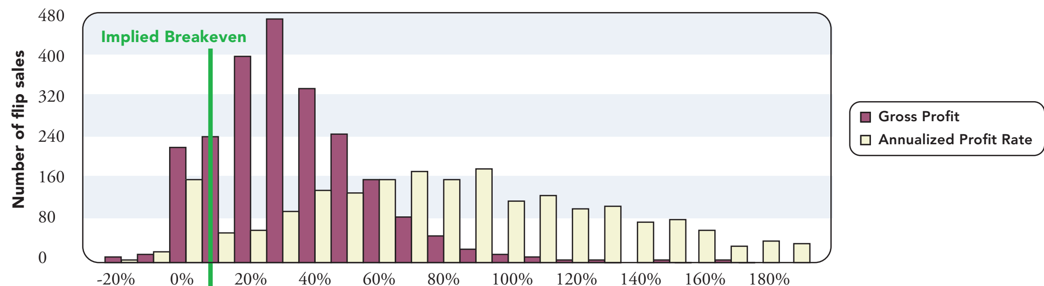


Figure 8
Gross and Annualized Profit, 3 to 6 Month Flips, Clark County, NV, 2004



As the figures show, flippers almost always made 15 percent or more gross profit; many of the sales that made less, or actually lost money, were likely to be involuntary or were not "pure" for-profit flip sales.

In fact, three-to-six month flips often did far better than 15 percent. And when the gains were converted to an ***annualized*** basis, the appreciation rates often exceeded 50 percent and even 100 percent. These profit rates were extremely strong in Clark County, with Miami-Dade County in second place and Orange County in the third position. However, those positions are relative, since even in Orange County these flippers did quite well.

Profit Rates: 6 to 12 Month Flips

Figures 9 through 11 display the gross profit and annualized appreciation rate for this type of flipping in all three counties during 2004. Again, almost all flippers made over 15 percent; many did much better. The annualized profit rates were often over 40 percent, especially in Clark County.

Figure 9
Gross and Annualized Profit, 6 to 12 Month Flips, Orange County, CA, 2004

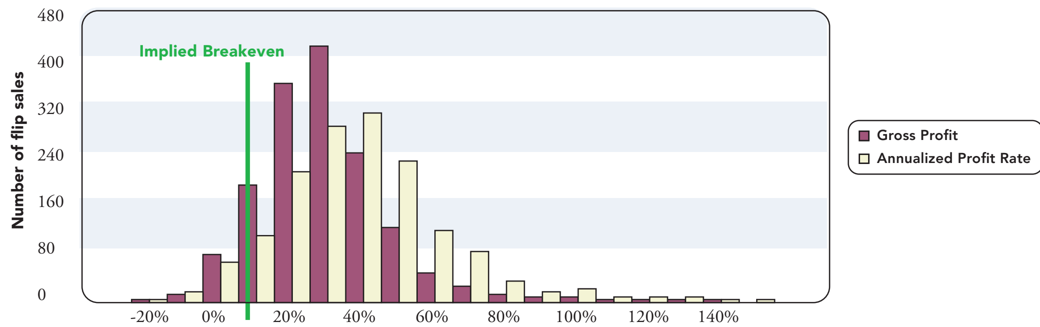


Figure 10
Gross and Annualized Profit, 6 to 12 Month Flips, Miami-Dade County, 2004

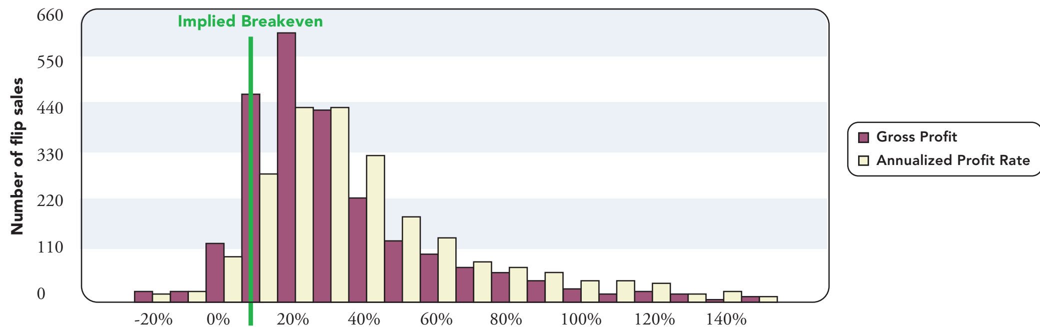
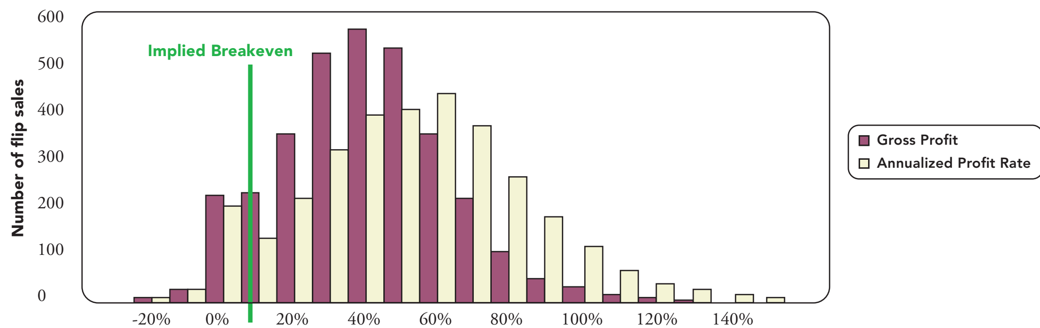


Figure 11
Gross and Annualized Profit, 6 to 12 Month Flips, Clark County, NV, 2004



Profit Rates: 12 to 24 Month Flips

Figures 12 through 14 display the gross profit and annualized appreciation rate. Since this time span exceeded one year, the annualized rate will be *less* than the gross profit. These flippers also did well, especially in Clark County.

Figure 12
Gross and Annualized Profit, 12 to 24 Month Flips, Orange County, CA, 2004

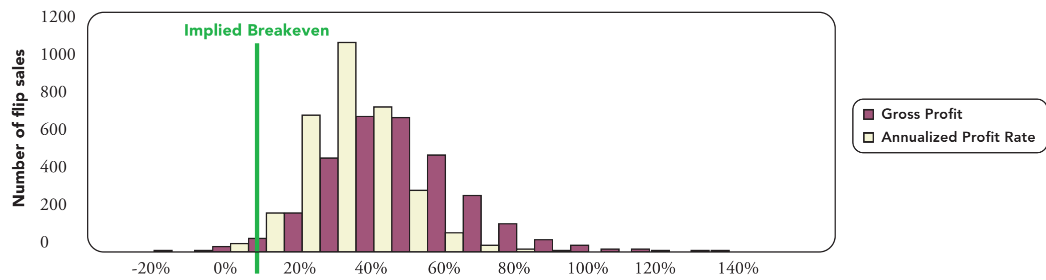


Figure 13
Gross and Annualized Profit, 12 to 24 Month Flips, Miami-Dade County, FL, 2004

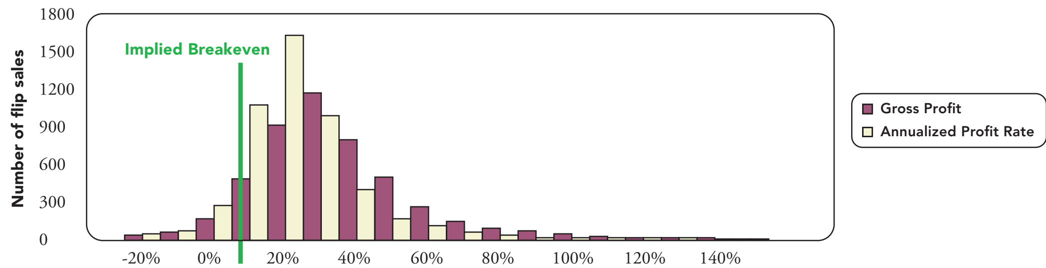
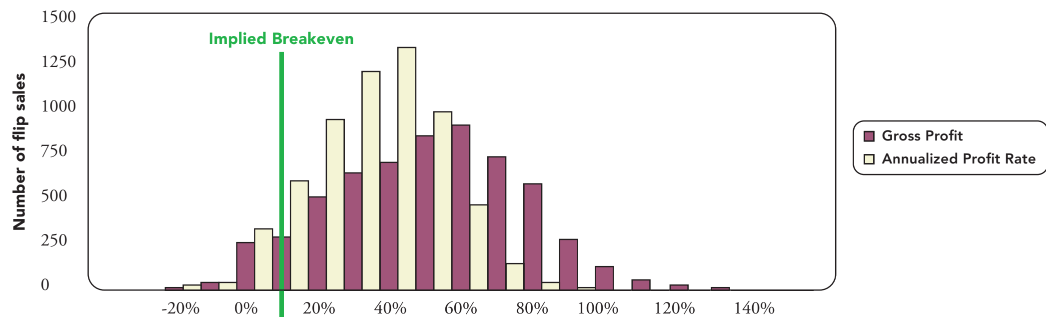


Figure 14
Gross and Annualized Profit, 12 to 24 Month Flips, Clark County, NV, 2004



Did Flippers Beat the Market?

It would be no surprise to learn that flippers got the same annual appreciation gains that their overall markets were getting; this would indicate that flippers merely participated in their markets on a general basis. In fact, however, flippers did *better* than their overall markets.

Figures 15 through 17 look at the annualized appreciation rate for different years of sale and different elapsed flip times – and compare that rate with the year-over-prior-year price appreciation of ***all*** single family residence (SFR) sale prices in each county – whether they were flip sales or not. This general appreciation rate will be called the "market" appreciation rate. The three figures look at the annualized appreciation rates in each county separately.

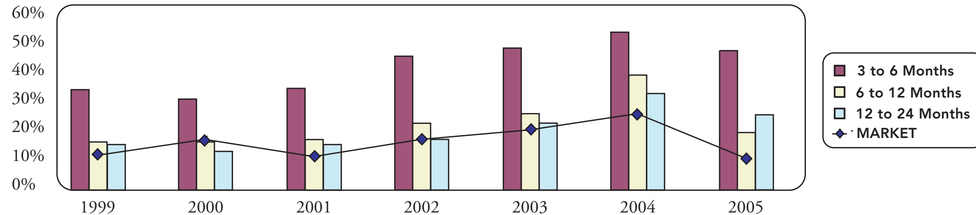


Figure 15
Median Annualized Appreciation Rates, Orange County, CA

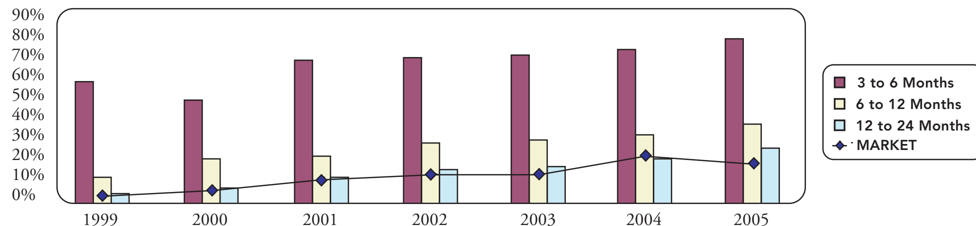
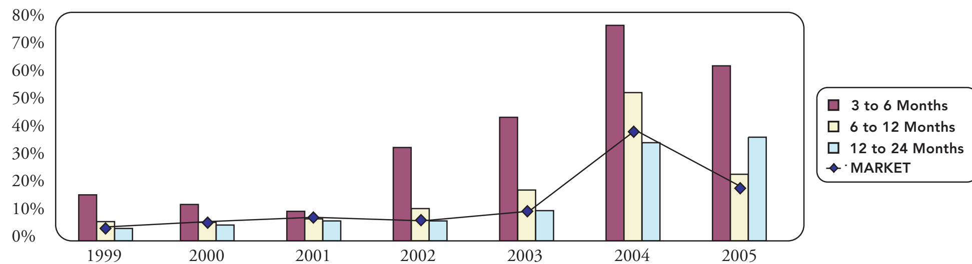


Figure 16
Median Annualized Appreciation Rates, Miami-Dade County, FL

Figure 17
Median Annualized Appreciation Rates, Clark County, NV



The three figures tell a consistent story about the rates of return on flip sales. In most cases, the annualized rate of return for 12-24 month sales was a little above or a little below the appreciation rate of the overall market. The annualized rate of return for 6-12 month flip sales tended to be a little better than that.

The “sweet spot” of flipping – what most people think of when they think of flipping – is the 3-to-6 month category (three to six months elapsed between recording dates). This represents an immediate or almost immediate turnaround of a purchased property back into the market. In all three counties studied, the annualized rate of return for 3-to-6 month flips was usually 20 percent to 40 percent or more above the market appreciation rate. In other words, when the market did well, flippers did even better. When the market boomed, flippers reaped almost incredible returns. Perhaps there may be some filtering behind the numbers: if a market was flat or falling, or even rising only slowly, a flipper might simply postpone the sale rather than take a loss or a poor rate of profit, and many fewer people would buy to flip in the first place. But those three markets were ***not*** weak; they were rising strongly, particularly in most months of 2004 and 2005. So it appears that flippers really ***did*** do better than the rest of the market – at least in the places and times studied here.

But ***why*** should flippers do so much better than the market in boom times? On the surface, it would seem reasonable that flippers get the ***same*** rate of gain as the market was getting. Why would they so often get (not merely individually, but on a group median basis!) double or even triple the annual rate of appreciation that the market was experiencing? Why wouldn’t they get the same level of return that the general market got?

The only conclusion is that flippers were exercising a level of intelligence and “savvy” ***above*** that of the general market! It looks like flippers, as judged by their returns, had more investing intelligence than the market in general. During 2004 and 2005, in the three counties studied, ***that was exactly the case.***

What special types of insight do flippers use in their investing decisions? Certainly they prefer to invest in the hottest local markets – in the most dynamic, fastest-rising zip codes and neighborhoods. Flippers often look for distressed properties, foreclosed properties, or residences in poor condition that they can repair and put back on the market at a higher price. Flippers often search for properties that are for sale at below-market levels. Flippers take advantage of any excited or hyped market psychology that exists. Flippers notice – and contribute to – a bullish market mood of discovery and a new-era sense of inevitable and spectacular gains.

In ***local*** areas where flipping was more prevalent than usual, flippers were all the ***more*** successful, again supporting the "flippers were smarter" position. Table 2 below presents the annualized rates of appreciation for 3-to-6 month flip sales in the same flip-dominated zip codes presented in Table 1.

In Las Vegas, the market in 2005 had slowed down from the previous year, but the flippers in the two zip codes shown still did very well. In Miami, the 3-to-6-month flippers in the hottest zip codes were (at an annualized rate) more than doubling their money in a year's time, assuming they could continue their short-term strategy and make the same gains across a full year.

Table 2
Appreciation for 3-6 Month Flips, Selected ZIP Codes

ZIP CODE	CITY	YEAR	Median Annualized Appreciation Rate Flips 3 to 6 Months
33127	MIAMI	2004	185%
33127	MIAMI	2005	117%
33142	MIAMI	2005	132%
33147	MIAMI	2005	157%
33150	MIAMI	2004	152%
33150	MIAMI	2005	150%
89119	LAS VEGAS	2005	72%
89147	LAS VEGAS	2005	42%

Clearly, no market can rise by 100 percent or 150 percent every year indefinitely. At some time the market must slow down, flatten, or even decline. Since no one wishes to lose money, flipping-for-profit will almost disappear during a declining market (the main exception being foreclosure resales). In a flat or declining market, most quick resales will be done for other reasons than for-profit flipping. Flipping emerges in strength during a rising market, yielding spectacular gains. Flipping ends at the top of a market cycle and lies relatively dormant until the next bull market phase begins.

In conclusion, you may wonder what happened to the house across the street from mine. As of the time of writing, Mr. Z had not sold the house, nor put it up for sale – but he had not moved in either! What does the future hold? Only time will tell.