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Cleveland Is a House-Flipping Hot Spot, and Covid Adds Fuel

Real-estate investors are moving away from the Sunbelt to lower-price markets inland, scooping up homes to turn into rentals

By Ryan Dezember | Photographs by Andrew Spear for The Wall Street Journal

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CLEVELAND—Economic upheaval has investors hunting for cheap houses. Many are finding them on the shores of Lake Erie.

The pandemic has stoked demand among investors, who were already buying more than one of every 10 homes sold in the U.S. They started gorging on houses after the last recession served up millions of foreclosures, and they've kept buying despite rising home prices, wagering on a permanent suburban rental class.

The current crisis strengthens the case for rentals. Homeownership is at risk of slipping further beyond the reach of many Americans. At the same time, spacious suburban living is en vogue. Other options for steady investment returns are limited.

That's where Cleveland comes in.

Greater Cleveland has been one of the most profitable places in the country to flip houses and own rentals. The typical fix-and-flip project there, as elsewhere around the Great Lakes, sells for twice what it cost. The monthly rents collected often meet the landlord's ideal of at least 1% of the purchase price.

California property-investment adviser Kathy Fettke steers clients clear of the Sunbelt cities where Wall Street gobbles up houses and surging prices have squeezed margins, guiding them instead to northeastern Ohio.

"When we take people from California, they see these beautiful homes and beautiful tree-lined streets; it's like stepping back in time to what America was in the '50s," Ms. Fettke said.

Home prices are a blast from the past too, which is the real draw.

Nico Vonderau, who works with Ms. Stumphauzer, checks out a run-down house for sale.

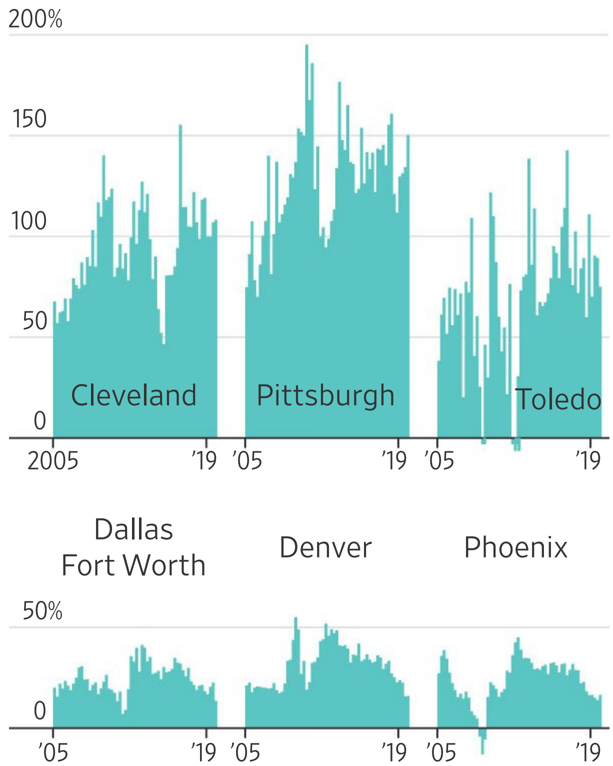
The median in metro Cleveland is $160,700, according to mortgage data and analytics firm HSH. That is well below the national median price of $274,600. Even better, there are plenty of run-down old houses to be had for less than $100,000.

Kelly Stumphauzer's job is finding them. Her house-flipping firm, Prosper Cleveland, last year sold about 200 renovated rental houses to investors. It has nearly 60 fix-and-flip jobs ongoing and a waiting list of individual investors that has grown since the pandemic began.

Ms. Stumphauzer drives slow and overshoots destinations by a block or two so she can circle back, eyes peeled for sagging porches and boarded windows, the sort of decrepit properties that can be bought for $50,000, gut renovated, leased, then sold for $115,000 to some yield-starved saver interested in rental income.

"We cannot turn them out fast enough," she said.

Change in price from original purchase to resale on flipped houses*



*Houses resold within a year of purchase
Note: Quarterly median sales price data, which don't reflect costs such as renovations, transaction fees or other expenses.
Source: Attom Data Solutions

The pandemic spooked a few of her California buyers, she said, but there were more lined up behind them. To boost supply, she is exploring a build-to-rent business and planning to broker deals between investors and landlords looking to cash out without ousting their tenants.

Another company she owns manages about 600 rentals on behalf of investors. Tenants in 25 requested payment plans due to virus-related financial hardship. After dwindling for a few weeks while Ohioans hunkered down, showings to potential renters are back to pre-pandemic levels.

Wall Street's growing role in what used to be the highly local rental-home business has produced national data that help investors find low house prices paired with stronger markets for leasing. Even in many places where home prices are low, like Cleveland, a mix of factors has propped up rents, including employment patterns and the state of the local housing stock.

National home-rental firms Invitation Homes Inc. and American Homes 4 Rent also reported strong occupancy, showings and rent collection despite widespread job losses.

Contractor Juan Gonzales works on a home owned by Ms. Stumphauzer.

Mortgage delinquencies doubled between March and April to nearly 3.4 million, according to Black Knight Inc. That could put more foreclosed homes on the market for investors.

Invitation Homes raised about $450 million selling shares last week. “We thought it would be opportunistic, if available to us, to have a little extra dry powder,” said Dallas Tanner, chief executive of the 80,000-home company

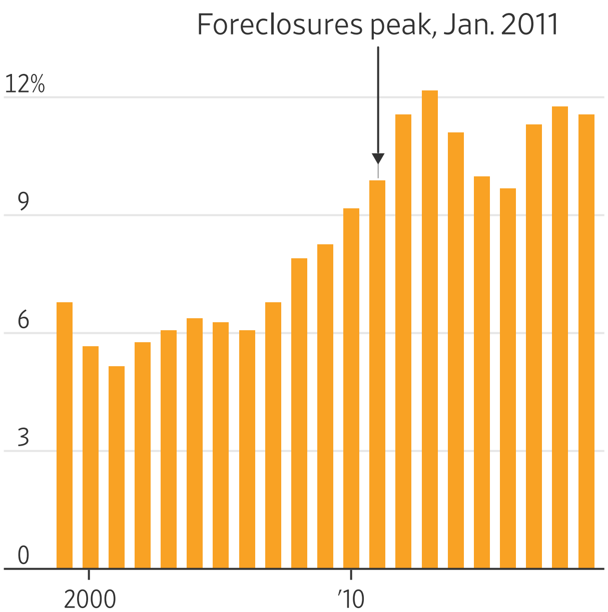
In February, American Homes 4 Rent disclosed a $220 million venture with J.P. Morgan Asset Management to build rental houses in the South and West. They enlarged the pact to $650 million last month. The asset manager bet millennials would seek spread-out suburban living as they started families and that many Americans would have trouble getting mortgages due to their limited savings for down payments and stricter underwriting.

“That’s only been reinforced, unfortunately, by the pandemic,” said Mike Kelly, the investment firm’s head of real estate.

Home Run

A mix of investors ranging from big firms to individual landlords and speculators have bought about 10% or more of the houses sold in the U.S. since the foreclosure crisis.

Portion of home sales purchased by investors



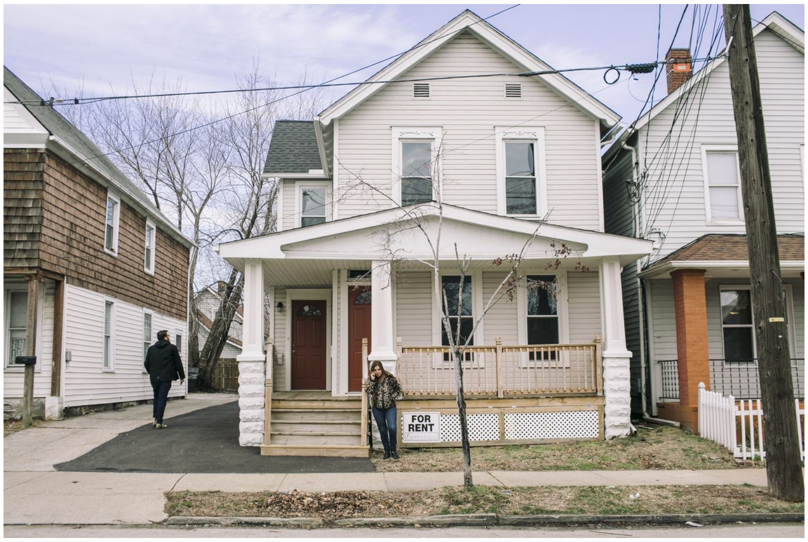
Source: CoreLogic

Nearly 246,000 U.S. homes were flipped last year, according to Attom Data Solutions, which tracks sales in 190 metropolitan areas and defines a flip as a sale within a year of another. Attom hasn't counted so many since 2006, when loose lending and rising home prices stoked a speculative frenzy.

The prevailing strategy then was to buy a house, stick a for-sale sign out front and sell it back into the rising market before the mortgage teaser rate or interest-only payment period expired.

It worked for a while. But then prices rose beyond what regular home buyers could afford, and speculators got stuck with houses for which they had paid top dollar. Prices fell, foreclosures flooded the market and a global financial crisis ensued. The flipper's M.O. ever since has been to turn out rentals, prized for the steady income they produce.

That crash created a lot of new renters and a new breed of landlord. Investors like Blackstone Group Inc. flocked to courthouse steps in Phoenix, Atlanta and Miami, bought foreclosures and started property management companies. Foreclosures eventually subsided. Demand for rentals has not.



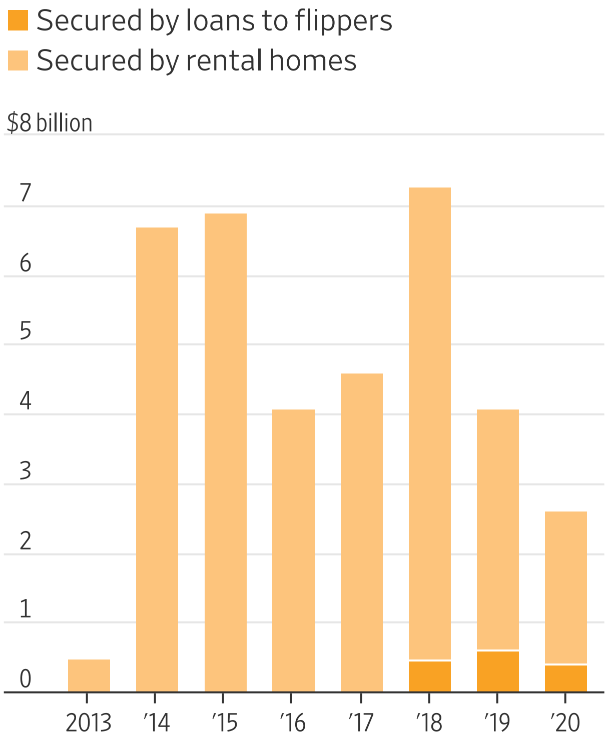
Ms. Stumphauzer in front of a home she renovated in Cleveland’s Tremont neighborhood.

Private-equity investors, sovereign funds and pensions piled in. Hedge funds, insurers and other big investors have bought $35 billion of bonds backed by pools of rental homes, including $866 million in May.

Silicon Valley backed high-volume flippers that use computers to spot underpriced homes and often sell to landlords. Financiers, including Goldman Sachs Group Inc. and KKR & Co., have funded billions of dollars of fix-and-flip jobs through lending arms and investments.

KKR’s Toorak Capital Partners LLC buys loans made to flippers and bundles them into securities. In early March, as the pandemic tanked markets, Toorak sold $400 million worth, most of which yield 2.75%.

Issuance of bonds secured by rental homes and loans to house flippers, annually



Note: 2020 is year to date.
Source: Kroll Bond Rating Agency, Wall Street Journal research (rentals), Toorak Capital Partners (flippers)

That's not much. Flips often flop. But it's hard to earn much income with the two-year Treasury yielding around 0.2%. Meanwhile, the stock market has been frothy and turbulent on its wildest ride since the Great Depression.

Data on flips isn't available yet for this year, though home sales have surged since shelter-in-place orders have been eased.

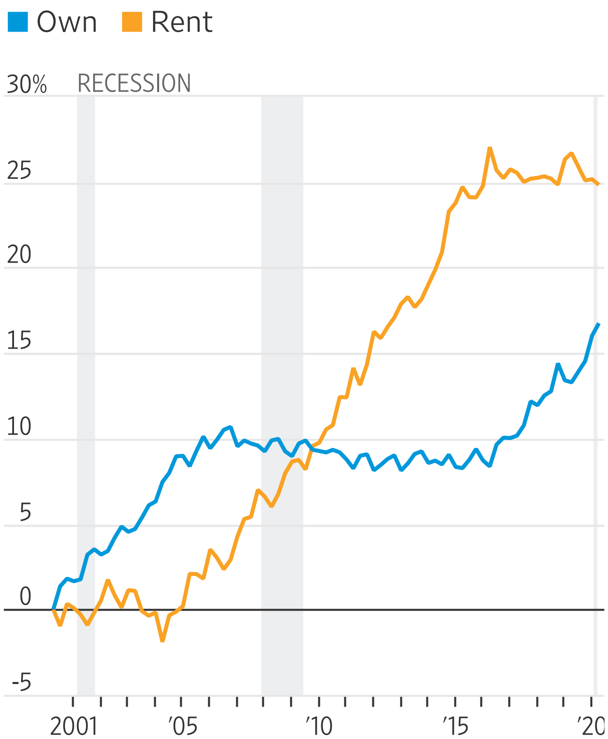
Individuals often buy rentals with self-directed individual retirement accounts, which allow savers to diversify beyond stocks and bonds. The Retirement Industry Trust Association says $5.6 billion of IRA money is invested in property and an additional $27.7 billion with limited liability companies, which usually own income-generating real estate. The spending power is even greater considering lenders will finance most of the purchase price.

Others are 1031 buyers, so named for the tax break that defers capital gains on the sale of investment property as long as the proceeds are plowed back into real estate. A lot of them can't wait out the pandemic and need to make new purchases if they want to keep their tax bills down.

The demand for houses to turn into rentals has compressed the profits in a resale. The median-priced U.S. flip house last year was bought for $155,000 and sold for $217,900, Attom says. The 40.6% gap hasn't been so narrow since the depths of the foreclosure crisis eight years ago, when flippers struggled to unload homes for which they had paid high prices.

The margin doesn't factor in financing, which would boost profits. But it also doesn't account for rehab costs, transaction fees and such, which Attom says usually consume up to a third of the sales price.

Change in households that rent or own their homes since 2000.



Source: U.S. Census Bureau

In Denver, where home prices have doubled since 2012 amid an influx of finance and tech workers from the coasts and rental investors in pursuit of high-earning tenants, the median flip fetched just 19% above the original price.

In Phoenix, where computer-guided flippers Opendoor Labs Inc. and Zillow Group Inc. have bought thousands of houses, the margin was 15.1%—down from 45% when Wall Street dispatched buyers in 2012 to buy up foreclosures.

Ms. Fettke, the property-investment adviser, and her husband refinanced their house near San Francisco in 2005 and used the cash to buy five houses outside Dallas. They rented them profitably and started a business, Real Wealth Network, teaching others to invest like that. But the math doesn't really work anymore in Dallas, where HSH says home prices have risen 78% from their precrash highs.

It still works in Cleveland. Last year the median flip house cost $60,000 and sold for $124,000, Attom said. Margins also exceeded 100% in Akron, Ohio; Pittsburgh and South Bend, Ind.

A west side neighborhood of Cleveland in which Ms. Stumphauzer has been investing.

That's where Steven Kollar buys and manages houses for investors. Mr. Kollar's firm bought in Atlanta and Birmingham, Ala., until it could no longer find enough properties that met the 1% rule: for example, a $100,000 house that rents for $1,000 a month.

"So many areas don't offer that anymore," he said.

Home values there and over the Ohio line in Toledo and Cleveland haven't kept up with those in other cities, but rents have, said Beth O'Brien, who has lent against thousands of rental properties as chief executive of CoreVest American Finance LLC, which bundles the debt into securities.

"Your basic three-bedroom, two-bathroom house doesn't rent for that differently in Ohio than it does in California," she said. The Ohio house might cost 90% less, though.

Cleveland-area houses that size rent from $1,100 to more than $2,500.

CoreVest lent George Nakhle and Rich Gutzky $20 million to double their stable of 700 rentals in northern Ohio. They bought three fixer uppers in late April but have paused to see where home prices head, said Mr. Nakhle. Meanwhile, they have to worry about collecting rent. The economic shutdown took a toll on their tenants, and just over half are paid up.

John Blatter has had better luck collecting. The Salt Lake City man and a partner flipped foreclosures around San Francisco after the crash, making 50% a pop until investors with deeper pockets elbowed in. A friend mentioned bank-owned homes in Cleveland's southeastern suburbs selling for less than $50,000. With $15,000 of work they would rent for $1,100—1% and then some.

Contractors work on a home being flipped by Ms. Stumphauzer.

Starting in 2013, they bought 34 close to Cleveland Clinic's sprawling east side medical campus. The pandemic disrupted appraisals to appeal tax bills and refinance, but not cash flow.

"We have a lot of nurses that rent from us," Mr. Blatter said. "Keeping them rented is no problem."

On the west side, MetroHealth System's hospital is undergoing a billion-dollar expansion that is expected to enliven a worn-out section in which the other neighborhood businesses include a place to sell plasma and a strip club called Peek-a-Boo.

Across the street from the hospital, behind a carwash, is a 145-year-old duplex that Ms. Stumphauzer bought for $40,000. A husband and wife are renovating it. She designs, he's foreman. Their son is upstairs with a five-gallon bucket of "Agreeable Gray" paint, a "greige" from Sherwin-Williams Co. , which is building a new headquarters downtown and a lab in the suburbs—part of the uptick in Cleveland's prospects.

A 1031 buyer has agreed to pay $160,000 for it, tenants included. Ms. Stumphauzer expects a total rent of $1,800. Leaving, she goes the long way to the thoroughfare. Driving for dollars.

“Look,” she said, stopping the car. “It’s caving in and boarded up.” She raised her phone and photographed a derelict house. Her deputy, Nico Vonderau, jotted down the address so he could look into its availability.

Ms. Stumphauzer quit her job in pharmaceutical sales when she started having children but found being a stay-at-home mom didn’t suit her. In the early 2000s, a want ad sought someone to bird-dog property deals. It paid $500 a house.

Her months-old daughter napped in the back seat as she cruised, looking for distressed properties. She watched remodeling tutorials and taught herself electrical panels and roofs.

Ms. Stumphauzer in the renovated kitchen of a rental house she flipped to an investor.

She bought her first rental in 2004, and started flipping when the market really heated up. After the crash, $120,000 houses sold for $20,000. Yet they still rented for $1,100 a month. She got a real-estate license and began brokering deals for investors.

At another rehab job, chunks of wallboard flew from an upstairs window into a waste hauler below. There was a surprise next door. An orange-and-black for-sale sign was taped inside the front window, as if it were an old car in a parking lot.

Ms. Stumphauzer paid $50,000 for the house from which debris was flying. It was built in 1925, when Cleveland was one of the country’s largest and most prosperous cities. An investor agreed to pay $120,000 once it was remodeled and rented.

Workers stripped it to the studs, careful not to nick the thick wood trim, which was in good shape. Whenever possible, Ms. Stumphauzer likes to retain old design elements, like woodwork and the stained glass windows that were common in that era. In weeks it would be rent ready, redone with a kitchen island and bright-white bathrooms.

Before they left, Mr. Vonderau dialed the number on the sign next door. The seller wanted $60,000.

“Single?” Ms. Stumphauzer asked.

“Double,” he said. Zoned a duplex. Two units, two rents.

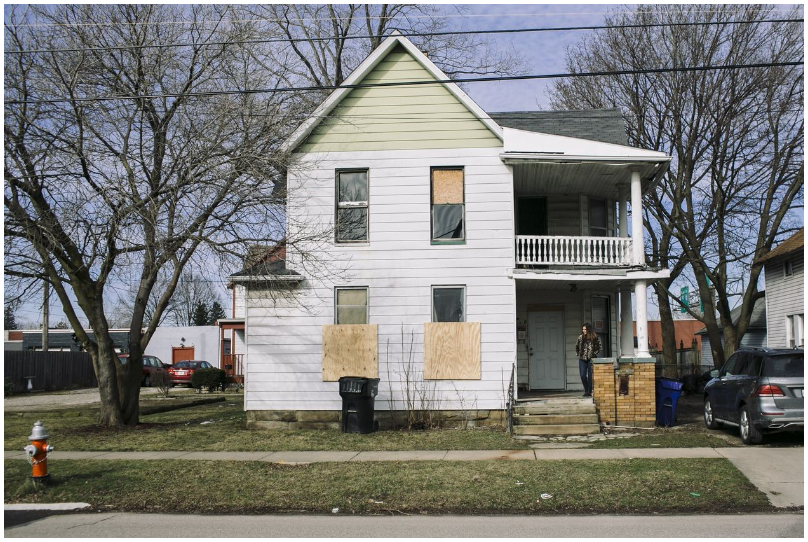
“Nice!” she said, high-fiving him across the center console.

With luck it will be a renovation more like the sturdy-but-stale house that they were driving away from and less like the nightmare they had undertaken a few miles away. That one cost $30,000 for a reason. Even though it was in a stable neighborhood, there were problems with squatters, maybe also raccoons. Someone had climbed up and busted out a second-floor window after the ground floor was boarded.

Mr. Vonderau unlocked the door and peeked inside to ensure it was empty.

It reeked of cigarette butts and cats. Speckled fly paper dangled from a doorway in which comically ill-fitting doors hung saloon style. There were needle caps on the plywood floor, mounds of soiled clothing, a child’s tiny socks and evidence that other mammals had been inside. Power was MacGyvered, the couch had no cushions and built-in curio cabinets were packed with empty tequila bottles and trash.

“This is the type of stuff we take on,” Ms. Stumphauzer said, stepping toward the kitchen. “Plug your nose.”



A purchase by Ms. Stumphauzer where renovations haven't yet begun.

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