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## REPORTER

Information and Risk Management Ideas for Real Estate Professionals

## Buying and Selling Vacation Homes

### Case Study: The Outer Banks Experience

Everyone loves a good vacation. Perhaps your idea of time off is to helicopter onto the summit of a glacier or trek the old Incan trail to Machu Picchu. Or maybe you're partial to visiting art museums or like to spend your holidays learning how to make gourmet meals.

If you're like most Americans, you're apt to participate in a family get-together at least once every two to three years, says the travel industry. According to the Travel Industry Association of America (TIA), multiple generations of families are increasingly vacationing together, whether it's taking a cruise, settling into a resort hotel or sharing a rented house by the seashore.

Indeed, beach destinations are always popular. The TIA reported in its 2004 Domestic Travel Market Report that beach vacations—many at least a week long—are "one of the most popular travel activities." All of which adds up to a thriving business for investors with beachfront properties.

North Carolina's Outer Banks alone contains \$10-\$15 billion worth of rental real estate, and a typical 8-bedroom home can generate revenues in excess of \$100,000 annually. With so much money at stake, any misstep can be costly. So it's critical that real-estate professionals understand their responsibilities and undertake appropriate due diligence.

This issue of Risk Management Reporter spotlights the Outer Banks. No, we're not making recommendations for

where to spend your next holiday; but we wanted to take one vacation market and examine the top issues that sales and property management companies face in representing their clients. Hopefully what we have learned will provide insights for everyone who handles vacation homes.

"North Carolina's Vacation Rental Act governs how individuals rent and how property management companies conduct themselves," explains Jeff Malarney, general counsel for Twiddy and Co. "It's fairly strict and explicit."

Under the law, whenever an offer of purchase is made, the seller must turn over copies of every pending rental agreement to the buyer. Much as condominium buyers in almost all jurisdictions are given a time-certain window in which to examine bylaws, operating budgets, reserve fund records, and other key documents, purchasers on the Outer Banks are given the opportunity to scrutinize their potential revenue stream.

In addition to understanding the Vacation Rental Act—a must for North

Carolina-based agents—there are several other unique aspects to buying and selling vacation homes. Most notable are flood insurance requirements, environmental concerns and the accuracy of property descriptions.

Under Freddie Mac and Fannie Mae requirements, lenders must carry up to \$250,000 in flood insurance from the Federal Emergency Management Administration if the property in question sits in a designated flood zone.

Flood insurance requirements, which are certainly not unique to North Carolina, are a hot topic of conversation in the Outer Banks these days. The federal government recently mandated that new flood maps be adopted—with significant impact to the region. Whereas most of the property in the region has been classified in the best zone for the last 20 years (meaning no flood insurance is needed), the vast majority will now be re-designated into the worst zone—which can mean \$7,000 in additional insurance for property owners. The new zones take effect in December 2005.

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## The Outer Banks Experience *(cont. from front)*

"These new flood insurance maps will particularly impact the fourth and fifth row homes which aren't achieving an equivalent before-revenue stream as the oceanfront properties," says Malarney.

With flooding comes the risk of damage from mold—as well as other environmental factors that affect the Outer Banks and other coastal communities. Salt, erosion, and storm-related issues need to be kept in mind. In addition, many homes rely on well water, which is safe to drink but generally doesn't taste very good. It's important that these issues are disclosed to potential buyers.

Sewage is also a concern in the Outer Banks. There is not much of a sewage system in place, and most homes rely on septic tanks. This isn't generally a problem—unless an owner has added bedrooms without adding septic capacity at the same time. So it's important for real estate agents to examine the septic permit to see how many bedrooms are covered.

Indeed, agents always need to be very careful when listing properties. They must accurately describe the size of the home, the number and size of the bedrooms and extras, such as pools or jacuzzis. While this sounds like a no-brainer, it turns out

that it can be a tricky proposition.

"Remember: more bedrooms equals more money," says Malarney. "In order to generate more income, a lot of homeowners have come in after the fact and enclosed their downstairs to add one to two bedrooms and perhaps a game room as well. And they may or may not have received the required permits."

Agents get in trouble when, for example, they advertise a property the seller is representing as a six-bedroom home but the county records shows has only four bedrooms. When the county assessor comes around, the unwary purchaser says, "My agent told me it had six bedrooms"—and that's not the place where any agent wants to end up.

Finally, it's important to manage a purchaser's revenue stream expectations. "There's a tendency when we're selling a property to say that it will generate \$75,000 or 20 weeks of rental income per year. But the reality may be that there are only 13 weeks of rentals to be had, especially in a tough market," says Malarney. He adds that real-estate professionals should also refrain from offering financial advice, including cash flow and investment analyses. ♦

## Property Managers Can Help Agents Manage Buyer Expectations

While the Outer Banks may be a mecca for vacation-goers, the lure is equally strong for investors. In a property market where most closing settlements are known as "mail-aways" and most landlords live out of state, property management companies end up being the key liaison between owners, lawyers, and renters.

Jeff Malarney told Risk Management Reporter that his firm encourages agents to have their clients meet directly with potential property-management firms. In addition to handling the rental side of the business, says Malarney, a good property management firm can help manage a buyer's expectations from the beginning. This includes:

- What is included in a typical property management agreement.
- The cost of maintaining the property each year.
- The likely rental income stream.
- Anticipated commissions and fees, from the company's per-rental commission to twice-weekly pool cleaning fees.
- How to build reserves, so an owner isn't caught empty-handed if the air conditioning system needs to be replaced or the elevator needs repair. ♦