

Why invest in real estate?

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Potential for appreciation

Residential real estate has proven to be a good investment over the years. Over the long term values have continued to rise in Boulder County. However, there certainly have been times when market conditions have slowed sales and prices dipped. An old saying is, "Buy real estate and wait". In Boulder County, if you bought in the 1980s, you would have bought and waited. In the 1990's appreciation was much stronger and a profit could be made after waiting only a short time. The primary reason appreciation occurs is job growth. If job growth is occurring new families move into the area and need a place to live. If job growth stops, the real estate market levels off. Job growth is even more important than interest rates on the overall market. Lower interest rates tend to stimulate the local move up market.

Debt Reduction

Every month when a payment is made on the mortgage a certain amount goes toward principle reduction. If one of your goals is to have free and clear real estate you can create a payment schedule on a 30 year loan that will pay off the loan in what ever time frame you want. In most cases, the rent received is covering the mortgage payment. Each month that goes by the tenant is helping you pay off your loan and build your equity.

Leverage

The concept of leverage is what is known as using "other people's money" or OPM. When you invest in real estate it makes the most sense to get a loan for a good portion of the purchase price. To illustrate an example of leverage, let's say you had \$100,000 to invest. You then used that money to purchase one \$100,000 condominium. If the real estate market were appreciating at 5% a year and you held the property for 5 years the condominium would be worth \$122,347 or a gain of \$22,347. Now lets say that you took that same \$100,000, put \$20,000 down on each of five \$100,000 condominiums. You now own \$500,000 worth of real estate. If these units appreciates at the same 5% a year for 5 years they would be worth \$638,140, or a gain of \$138,140 on the same \$100,000 investment. As you trade up it is important to keep your equity position at a level where you can survive any downturns in the rental market.

Tax Break

You should consult your tax advisor on how ownership of real estate will affect you personally. However, the main reason you get a tax break is due to what is called “depreciation”. Depreciation is a tax concept whereby you take a tax write off but you don’t have to spend the actual dollars to get it. For example, on a \$100,000 purchase, your accountant may choose to declare 80% of the value as depreciable. You can’t declare the whole value as depreciable because some of the value is attributed to land and land doesn’t “depreciate”. Therefore, in this example \$80,000 would be depreciable. Under the current IRS rules, you can take the \$80,000 and divide it by 27.5 years for an annual depreciation deduction of about \$2900. In addition to depreciation, real estate taxes and other expenses of the property can offset rental income. The bottom line is that real estate in the early years of ownership will show a loss, which results in a tax deduction and tax savings for you. There are limits as to the amounts you can deduct due to real estate losses. Depreciation can also be “recaptured” at the time of sale, which means that you have a higher taxable gain. Be sure and consult your accountant to determine how all the IRS rules will affect you.

Cash Flow

In the early years of ownership it may be difficult to achieve an immediate positive cash flow with which you can “spend at the grocery store”. In other words, when you first buy a property the rental income probably won’t cover the mortgage payment and all the expenses. If the cash flow is about break even on a month to month basis, after you consider taxes and appreciation factors, the overall cash flow is positive. After owning the property for several years, rents should go up, the mortgage payment stays the same (except for increases in taxes and insurance), and the monthly cash flow increases.

Liquidity--Conversion to Cash

Real Estate is not a “liquid” investment compared to many other investments available. If you need to sell a property to generate cash, market conditions will dictate how salable a particular property will be. Generally speaking, individual housing units, whether single family or condo, have been readily salable in our market place. However, you do not need to sell a property in order to generate cash. If you have owned the property for a while and its equity has increased, you can refinance your loan to pull cash out. With refinancing you don’t have to pay any selling expenses or pay any tax on the cash pulled out. You can use the money for daily expenses, other investments, or for the down payment on another rental property.

Single Family for appreciation

In my market place -- Boulder, Colorado, the rents compared to the value don’t make much sense. So why do people still buy them as investments? They hope that the appreciation rate will cause the value of house to increase so much that the monthly cash flow isn’t all that important in the long run.

Multi-units for Cash Flow

Typically a single family residence will have a higher gross rent multiplier (GRM) (see explanation of GRM below). The greater the number of units in a building the lower the gross rent multiplier typically is. When trading a single family for multi units usually you won't see much change if you just make a move up to a 4 unit. The best increases in cash flow come when you can make the jump to 20 plus units in one location.

Comparing Residential Real Estate to Other Possible Investments

Residential real estate investments can be ideal for most anyone. The first real estate purchase can typically be made without a lot of capital or experience.

Stock Market-- The stock market tends to have many more ups and downs than the real estate market. The stock market is a gamble for most passive investors. If you are an experienced and knowledgeable investor there are certainly opportunities to make money. Every time stocks have a downturn investors often turn to real estate because it is typically a more stable investment. It is also possible to use leverage in the stock market by purchasing on "margin". However, if the stock turns down in value you'll end up with only a debt to pay.

Savings Accounts-- Savings accounts are a great safe place to save money. As an investment, taxes on the income and the rate of inflation will often offset any gains from the interest payment received.

Gold and Silver--For the knowledgeable investor there are certainly opportunities in gold and silver to make money. Again, for the passive investor, this market is very risky.

Vacant Land--Buying land in the path of progress is a great idea. However, while you're waiting for progress to catch up, holding costs, such as debt service, taxes, etc can eat up any future return on the investment.

Commercial Real Estate--Commercial tenants tend to have more specialized needs. Often when a commercial tenant moves out the entire interior of the building needs to be redone. If a large commercial tenant moves out it could take a considerable period of time to re-lease the property.

Comparing One Real Estate Investment to Another.

There are several rules of thumb that help you compare different investment properties. The perfect comparison would account for all factors involved in a real estate investment—rent amounts, purchase price, initial investment, appreciation, depreciation, expenses, loan amount, holding period, and time value of money, exact future sales price and tax liability upon sale. None of the following methods are “perfect” comparisons; they all have their advantages and disadvantages.

Gross Rent Multiplier (GRM)

The most commonly used rule of thumb is called the Gross Rent Multiplier. It simply compares the price of the property to the annual gross rent. Part of the reason the GRM is popular as a rule of thumb is that on each listing sheet in our Multiple Listing Service (MLS) for income property a GRM is calculated by the computer and shown on the listing sheet. In general, the lower the GRM the better the value is to the investor. The GRM’s drawback is that it only considers rent and price out of all the factors listed above.

Capitalization Rate (Cap Rate)

This is popular because it is also easy to compute. It is arrived at by dividing the Net Operating Income by the price. The Cap Rate is also indicated on the MLS sheet for each property. In theory, this is a better measure than the GRM because it considers the Net Operating Income (Rent less the expenses of the property). The problem with this technique is that the expenses of the property are rarely reflected accurately in the MLS and often are not accurate even when they come directly from the owner. If the expenses are in error, and the MLS computer calculates the cap rate, you have “garbage in -- garbage out”. Therefore, for this rule of thumb to have the most meaning to an individual investor, it is best to try to figure out what expenses are exact for each property and add realistic estimates for total expenses for each property analyzed. The other drawback is that the Cap Rate only considers rent, expenses, and price out of all the factors listed above.

Cash on Cash Return

Cash on Cash is one of the easiest techniques to use to compare real estate directly to a more liquid investment. Simply take the annual cash flow after expenses, but before taxes, and divide it by the initial investment. The result is a percent return that you can compare to other investment vehicles. The drawback of this technique is that it only considers rent, expenses, and initial investment out of all the factors listed above.

Debt Coverage Ratio

When applying for a loan most lenders will consider a ratio called the debt coverage ratio. This ratio compares Net Operating Income to the Principal and Interest payment. Lenders will typically want to see a ratio of 1.2. Lenders will be using their own formula for computing NOI. Variances will occur with how lenders estimate for expenses and vacancy allowances.

Internal Rate of Return (IRR)

The IRR is probably the best comparison of all. This is used by the most serious investors, but in general is probably used the least because it is the hardest to calculate. This comparison considers many more of the factors listed above, but its accuracy is limited by the accuracy of expense information available, correct mortgage figures, accuracy of prediction of future cash flows (rents and future sales price), accuracy of predicted investor tax bracket at time of sale, etc. Even though the theory behind the IRR is great, it's still just a guess on how the property might perform in the future. The best example of how inaccurate it might be is the appreciation factor. Let's say in your analysis of past data the appreciation rate has been 8% a year. Just after you purchase a property the real estate market slows and the appreciation rate is actually 4% per year over the time you own it. The difference between those two numbers significantly affects the IRR. Using IRR does provide a great opportunity to put "real numbers" into the formula after you have owned the property for 5 years, sold it and paid the taxes on it. With those "real numbers" you can truly compare a real estate investment to other investments that competed for your investment dollar 5 years ago.

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