Investing in Real Estate

the single family home

Steve Hardy, MBA

Investment Options

- Single Family Homes
- Multi-Family Residential
  - Residential (2-4 Units)
  - Commercial (> 5 Units)
- Commercial
  - Shopping Centers & Retail
  - Office
  - Industrial
  - Hospitality
- Land
- REIT'S

Single Family Homes

- Benefits:
  - Plentiful
  - Easy to purchase & sell (liquidity)
  - Higher Appreciation than Multi-Residential
  - Financing (easy money)
  - Tenants prefer SFH over apartment → Higher quality tenant
- Disadvantages:
  - If homes in your portfolio are spread out, more difficult to maintain (compared to an apartment complex)
  - Can't hire on-site manager

Rate of Return on Real Estate

- Return is more complicated to compute than it is for stocks or CDs.
  - Stocks, Bonds, CD:
    - Return = Dividends + Appreciation (Depreciation) / Investment
- Real Estate: Four Components of Return
  - Appreciation (Depreciation)
  - Cash Flow
  - Principal Buildup (Mortgage Paydown)
  - Tax Savings

Real Estate Return

- Appreciation
  - Where the most amount of money can be made quickest
  - Example:
    - Own home worth $100,000
    - 3% appreciation year 1 – gain of $3,000 → Value $103,000
    - 3% appreciation year 2 – gain of $3,090 → Value $106,090
    - Represents $6,090.00 profit in 2 years (6.06%)
    - Assumes you paid CASH for the home.

Real Estate Return

- Appreciation – Continued…
  - Where appreciation gets interesting: LEVERAGE
  - Compare two $100,000 homes appreciating at 3%/YR

CASH	20% Invested
Home Value Year 1: $103,000	Home Value Year 1: $103,000
Return after Year 1: 3.00%	Return after Year 1: **15.00%**
Home Value Year 2: $106,090	Home Value Year 2: $106,090
Return after Year 2: 6.06%	Return after Year 2: **30.45%**
Home Value Year 3: $109,273	Home Value Year 3: $109,273
Return after Year 3: 9.23%	Return after Year 3: **46.37%**

Real Estate Return

- Cash Flow
  - With 20% invested in a property you should be able to get positive cash flow
    - If not, re-evaluate the market in which you are investing.
  - Positive Cash flow is not 100% necessary, but is nice as it compensates you for your efforts on a monthly basis.
    - Because there are three other components of return it is possible to still have a positive return even if you have negative cash flow.
    - Negative cash flow can <u>force</u> you to save.

Real Estate Return

- Principal Paydown
  - Refers to the fact that, all else being equal, you will eventually pay off your mortgage.
  - Small portion of each payment applied to principal at the beginning. Principal Paydown increases at an increasing rate the longer you have the mortgage.
  - Often called an *invisible rate of return*, but it IS real.
    - When calculating net worth: Banks will subtract current mortgage balance from home value to arrive at EQUITY.
      - *Very Important* when asking for more money from a lender.
    - Think of it this way: At end of loan term – no mortgage → no payments → large monthly cash flow!

Real Estate Return

- Depreciation (tax savings)
  - IRS acts if residential income property is depreciating in value.
    - Of course, if you buy in a good area and maintain it will appreciate, but don't argue with the IRS!
  - Depreciation allows you to shield some of your income
  - Can only depreciate the value of the building (not the land)
  - Example $120,000 property - 80% ($96,000) is the value of improvements , 20% ($24,000) is land value.
  - Can depreciate the improvements over 27.5 Years
  - $96,000/27.5 = $3,491 per year of depreciation
  - Decreases the basis on your property (for capital gain calculations)

Real Estate Return – Calculation

- What you need (five numbers):
  - How much you have invested
    - Down payment
    - Closing costs
    - Capital Improvements
  - Cash Flow After Expenses
  - How much your loan balance decreased
  - How much your property appreciated
  - How much you saved on your taxes

Real Estate Return – Calculation

- Example:

Real Estate Return – Calculation

- Determining Amount Invested:

Purchase Price	$124,500
New Loan	$99,600 (80%)
Down Payment	$24,900 (20%)
Closing Costs	$2,155
Capital Improvements	$0
Cash Invested	**$27,055**

Real Estate Return – Calculation

- Determining Cash Flow :

Income (11.5 Mo * $1,135)	$13,052
Expenses	
Taxes	$983
Interest	$6,047
Insurance	$909
Landscaping	$410
Maintenance	$1,019
Advertising	$160
Total Expenses	$9,528
Cash Flow (Income-Exp)	**$3,524**

Real Estate Return – Calculation

- Determining Appreciation:

Purchase Price	$124,500
Appreciation Rate	1.606%
Appreciation Amount	**$2,000**
Home Value	$126,500

Real Estate Return – Calculation

- Determining Tax Savings:

Purchase Price	$124,500
Value of the Improvements	$99,600 (80%)
Value of the Land	$24,900 (20%)
Depreciation Rate	27.5 Years
Depreciation per Year	$3,621.82
Tax Rate (different for each client)	22.5%
Tax Savings	**$815**

Real Estate Return – Calculation

- Summary:

Total Invested	$27,055	
Cash Flow	$3,524	13.03%
Principal Paydown	$2,022	7.47%
Appreciation	$2,000	7.39%
Depreciation (Tax Savings)	$815	3.01%
Total Return	**$8,361**	
Total Rate of Return	**30.90%**	

Real Estate Return

- There is a *Decreasing Rate of Return*:
  - The rate of return will decrease each year you hold your property. Why?
    - You have more money invested in the property through:
      - Principal Paydown
      - Accumulated Appreciation

Total Invested (Year 2)	$31,077 (2,022+2,000)
Cash Flow	$3,524 11.34%
Principal Paydown	$2,022 6.51%
Appreciation	$2,000 6.44%
Depreciation (Tax Savings)	$815 2.62%
Total Return	**$8,361**
Total Rate of Return	**26.90%**

Real Estate Return

- Increasing Rate of Return:
  - Refinance
    - New 1st Mortgage
    - New 2nd Mortgage (HELOC)
      - Both will draw money out of your investment decreasing the amount invested, thereby increasing your leverage and ultimately your yearly Return on Investment.
  - Sell the property
    - Consider utilizing a 1031 Tax Deferred Exchange to avoid capital gains taxes
  - Both options cost money (transaction costs) so they must be evaluated prior to undertaking.

Contact Information

Investment Property Consultation & Brokerage:

Steve Hardy, MBA

505-670-5604

Steve@SteveHardy.com

www.NMREInvestments.com