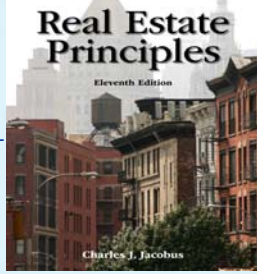


Chapter 27/ Chapter 25

Investing in Real Estate



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Sources of Return from a Real Estate Investment

- ▶ **Appreciation** – increase in property value over time.
- ▶ **Mortgage reduction** – the decline of the mortgage balance as payments are made.
- ▶ **Cash flow** – money left each year after paying property operating expenses and debt service.
- ▶ **Tax shelter** – tax savings and tax deductible expenses generated by an investment property.
- ▶ **Loan refinance** proceeds

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How to Find a Good Deal: CLEAR

- ▶ **Cash Flow:** Is cash flow necessary, what about the market, interest rate, expenses & maintenance, upkeep and repairs?
- ▶ **Leverage:** Using borrowed money increases return.
- ▶ **Equity:** Buying equity either by discounted price, fixer upper, rezoning, new management, distress sale adds value.
- ▶ **Appreciation:** Plan on long term investment.
- ▶ **Risk:** Manage risk, make sure you have back up plans in your investing strategy.

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Capital Gains

- Holding period longer than a year
- 15% tax rate (LTCG)
- Recapture taxed at 25%

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Investing Benefits

- ▶ Appreciation – increase in property value over time.
- ▶ Mortgage reduction – the decline of the mortgage balance as payments are made.
- ▶ Cash flow – money left each year after paying property operating expenses and debt service.
- ▶ Tax shelter – tax deductible expenses generated by an investment property.

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Cash Flow Projection

Rent receipts for the year	\$30,500
<i>Less operating expenses</i>	\$10,000
<i>Less mortgage loan payments</i>	\$20,000
Equals cash flow	\$ 500

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Taxable Loss

Rent receipts for the year	\$30,000
<i>Less operating expenses</i>	\$10,000
<i>Less interest on loan</i>	\$19,500
<i>Less depreciation</i>	\$ 8,000
Equals taxable income	(\$ 7,000)*

*In accounting language, parentheses indicate a negative or minus amount.

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Depreciation

- ▶ Straight-line or useful life
- ▶ Residential 27.5 years
- ▶ Commercial 39 years
- ▶ Capital Gains
 - Holding period longer than a year
 - 15% tax rate (LTCG)
 - Recapture taxed at 25%



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Calculating Equity Build-up

Equity at Time of Purchase		Equity 5 Years Later		Equity Build-up	
Purchase price	\$200,000	Market value	\$220,000	Current equity	\$100,000
Mortgage loan	-140,000	Less loan balance	-120,000	Less beginning equity	-60,000
Down payment (equity)	\$ 60,000	Equals current equity	\$100,000	Equals equity build-up	\$ 40,000



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Leverage

- ▶ The ability to use borrowed funds to purchase investment property.

Purchase Price	\$100,000
Cash Down	\$20,000
Loan	\$80,000
Leverage	80%



• Investor only needs \$20,000 to control \$100,000 property or 20¢ cash for each \$1 of cost.

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Property for Investments

- ▶ Vacant Land
- ▶ Houses & Condominiums
- ▶ Apartment Buildings
- ▶ Office Buildings



Property for Investments

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GLITAMAD

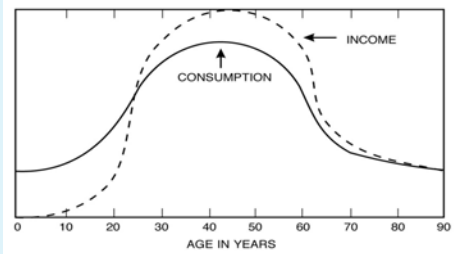
G	=	Ground (the raw land stage)	↑	Increasing risk, Increasing returns
L	=	Loan (long-term loan commitment)		
I	=	Interim (short-term loan and construction)	↓	Least risk, Least returns
T	=	Tenancy (building filled with tenants)		
A	=	Absorption (second through tenth year)		
M	=	Maturity (eleventh through thirtieth year)	↓	Increasing risk, Increasing returns
A	=	Aging (more than 30 years)		
D	=	Demise (demolition, reuse of the land)		

As the risk that an investor will suffer a loss increases, the expected returns must increase.

Phases in life cycle of improved real estate investment

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Lifetime Income/Consumption Patterns



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Bubble or Boom

- ▶ What is a bubble?
 - ▶ Rapidly increasing prices
 - ▶ Strong sales
 - ▶ Housing sales as percent of GDP (2005 about double of average)
 - ▶ (Unsustainable over long periods of time)

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Bubble or Boom

- ▶ What fuels a bubble?
 - ▶ Short supply of housing
 - ▶ Low interest rates
 - ▶ Refinancing & reinvesting
 - ▶ Higher income to home cost ratios
 - ▶ Low competition for consumer dollars
 - ▶ Speculation and investment

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Buying In Bubble Market

- ▶ Don't over extend
- ▶ Limit your housing costs to 25% and 32%
- ▶ Don't assume continued to appreciation
- ▶ Don't buy because you're afraid you'll miss out
- ▶ Don't buy just because you think it's a good investment.
- ▶ Don't indulge in cash-back refinancing
- ▶ Don't purchase with an interest-only loan
- ▶ Choose a modest home in a good neighborhood
- ▶ Avoid buying a house that has appreciated above the average rate

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Rent or Buy?

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Some Factors to Consider

- ▶ Location: rentals may be nearer than owned
- ▶ Investment factors (appreciation, tax benefits, other investment opportunity)
- ▶ Availability
- ▶ Home ownership responsibilities/maintenance
- ▶ Fixity vs. "Home Sweet Home"
 - Permanency
 - Mortgage Commitment

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Financial Calculators

- ▶ <http://crown.org/Tools/Calculators/> provides a number of quality calculators to help you in the home buying process including a “Rent to Own” calculator.

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Key Terms

- Cash flow
- Cash-on-cash
- Equity build-up
- Leverage
- Negative cash flow
- Prospectus
- Straight-line depreciation
- Tax shelter

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