CHAPTER 6

The Real Estate Market Investment

Abstract This chapter examines real estate investment from the homeowner's perspective and conducts a comparative analysis of the rent option. It also explores when renting might be the better option. Finally, this chapter illustrates the investment component of the residential real estate investment.

Keywords Appreciation · Leverage · Cash flows · Real estate investment

In this chapter, we will take a look at real estate investment from the homeowner's perspective, conduct a comparative analysis of the rent option, and explore when renting might be the better option. We will also discuss the investment component of the residential real estate investment.

From the Homeowner's Perspective

To homeowners, the typical real estate market investment is quite simple. There are upfront costs and ongoing carrying costs and benefits. Upfront costs are usually one-time payments that are incurred when a home is initially purchased. These include a down payment of at least 3–5 % of the selling price and closing costs associated with the loan. Although the closing costs vary depending on the lender and the buyer's offer, they cover such things as an appraisal, home inspection, credit check, insurance, and assurance that the title to the home is free (O'Hara 2007).

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Ongoing carrying costs include one's monthly mortgage payment, property taxes (which are based on the value of the home), home insurance, maintenance, and homeowner association (HOA) fee, if applicable. Mortgage payments are deductible on income taxes if itemization is utilized. Property taxes are also tax deductible.

The HOA fee is a "hidden" cost that must be paid monthly by owners of certain types of residential property, including condominiums and single-family houses in certain neighborhoods where there are common amenities like tennis courts, a community clubhouse, or neighborhood parks to maintain. This fee generally covers costs for city services such as trash removal, water, and sewage; insurance for damage to the outside of the building and surrounding property; lawn care; pest control; and maintenance and repairs to the outside of the complex. It could possibly increase from year to year as the costs of services go up. Additionally, the homeowners association may levy special assessments on occasion when there are insufficient funds in the HOA's reserve to cover major repair, such as a new roof or a new elevator. And, if owners do not pay the required monthly fee and any special assessments, the homeowners association has the right to foreclose on the delinquent homeowner.

Prospective homebuyers typically consider all these costs and conduct a comparative analysis of other options in the marketplace before making a decision to buy a specific property. They should also consider whether buying is the best option for them.

Comparative Analysis of the Rent Option

Since the housing bubble burst in 2006, more economists and real estate experts have taken to the Internet with comparative cost analyses to advise skeptic consumers whether it is better to buy or rent property in today's economy. One of the simplest calculations presented is the price-to-rent ratio (P/R ratio) or the rent ratio. A more complex analysis is Trulia's methodology, which was developed by the online real estate marketplace known as Trulia (Kolko 2013). Both analyses make the decision to buy or rent a purely financial decision.

Price-to-Rent Ratio

Checking the P/R ratio is done by finding two similar properties, one for sale and the other for rent, and dividing the sale price of one property by the annual rent for the other property (Roth 2012). For example, if one finds a house he or she would love to buy for $400,000 and also sees that a house around the corner is renting for $2000 per month ($24,000 a year), dividing $400,000 by $24,000 would give one a P/R ratio of 16.7. According to David Leonhardt, Washington bureau chief of the *New York Times*, when the rent ratio is below 15, most people should consider buying and when the ratio is above 20 one should definitely consider renting because a high ratio means the monthly mortgage bill will be higher than renting a similar property (Leonhardt 2011).

Although the national P/R ratio is usually between 10 and 14, during the recent housing bubble, the ratio came close to 20 and, in some cities, went far above (Roth 2012).

Trulia's Rent vs. Buy Methodology

In a 2013 *Forbes* article, Jed Kolko, chief economist at Trulia, indicated that, based on Trulia's methodology, "homeownership is (still) 44 % cheaper than renting in the top 100 major metros." This methodology involves calculating the following:

1. the average rent and for-sale prices for an identical set of properties over a period of time;
2. initial total monthly costs of owning and renting, including maintenance, insurance, and taxes;
3. future total monthly costs of owning and renting, considering price and rent appreciation and inflation;
4. one-time cost and proceeds, such as closing costs, down payments, sales proceeds, and security deposit; and
5. net present value to account for opportunity cost of money (Kolko 2013).

Trulia's method also assumes buyers put 20 % down, get a 3.5 % fixed rate mortgage for 30 years, reside in the 25 % tax bracket, itemize their federal tax deductions, and live in the home in question for at least 7 years (Kolko 2013).

For example, the calculated results for ten metropolitan areas are based on where buying a home is much cheaper than renting. The negative numbers indicate that it is cheaper (i.e., 70 % cheaper) to buy than to rent (Kolko 2013). The higher the negative number, the more sense it makes to buy property.

When Renting Might Be Better

Using Trulia's methodology, renting becomes the better option, when mortgage interest rates are higher than 3.5 %, buyers do not itemize deductions, and they do not plan to live in the same place for more than 7 years (Kolko 2013).

Renting is also the better option when one is looking to buy in a seller's market, in which case demand for homes exceeds the supply of homes for sale and those on the market sell quickly, which can drive up home prices. In this particular situation, the prospective homebuyer ought to make an offer promptly to the seller. Further, the prospective homebuyer has little room to negotiate with the seller since the seller has numerous offers to choose from.

Investment Component of Residential Real Estate

While some Americans struggle today with the decision whether to buy or rent a primary residence, others are looking to purchase residential real estate strictly for the purpose of generating income. They do not plan to live in the property or use it as a vacation home. The investment property is usually bought with the intent to either rent it out or renovate it to resell at a profit, although a primary residence can become an investment property in the event the owner needs to move but does not need to sell. Financial gains for real estate investments include cash flow, appreciation, and leverage.

Cash Flow

Cash flow from real estate investments is the excess of rental receipts after subtracting expenses of operating and owning the property. If one invests in quality real estate, cash flow should increase over time (Benchmark Group).

Appreciation

Appreciation refers to an increase in the value of the property and is only realized through selling or refinancing the property. Appreciation rates vary depending on regional and economic situations such as employment rates, interest rates, business growth, housing supply, demand, and affordability. The rates also vary depending on crime rate in the neighborhood, weather, quality-of-life issues, and the quality of schools and other factors, including home upgrades.

Leverage

Financial leverage, also known as trading on equity, is the use of debt (financial instruments or borrowed capital) to acquire additional assets. It is most commonly used in transactions through the use of a mortgage to purchase a home and increases the potential return of an investment. For example, if Harry purchases a home by investing $300,000 of his own money and borrowing $500,000, he is controlling real estate valued at $800,000 while having only invested $300,000 of his own money. If the property increases in value by 25 % and is sold for $1 million, Harry will gain $200,000, which is a 66 % return on his investment. Real estate investors who "flip" properties thrive on these returns. However, there is a flipside to the gains. If the value of the property decreases, then Harry, like all other Americans with upside-down mortgages, stands to lose money if he sells the property.

With this in mind, some may decide to invest in stocks or bonds rather than in real estate. The stock market has high risk and high volatility, in addition to being massively unpredictable, but offers the opportunity for quick return. Bonds are another source for investing in real estate. They offer a low, stable return with minimized risk. However, inflation can destroy earnings.

Summary

People purchase homes to either live in or profit from. When deciding to buy a home to live in, there are several things to consider, including upfront costs, ongoing costs, and the benefits of buying a home versus renting. To assist prospective homebuyers with this decision, there are various comparative cost analyses they can use, including the P/R ratio and Trulia's rent vs. buy methodology. The analysis Trulia conducted in 2013 shows that home buying is still 44 % cheaper than renting in the top 100 metropolitan areas, as long as interest rates stay below 3.5 % and buyers itemize deductions and plan to live in the same place for more than 7 years. When planning to invest in property for profit, investors need to consider possible cash flow, appreciation, and financial leverage.

References

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