

Why Buy Investment Real Estate

Leverage, Inflation and Wealth Accumulation

by Michael Bull, CCIM, CRB, ePro

Sometimes as investors, we may ask ourselves, why buy real estate. We know that all rich people own real estate, but why? If we look at the cash-on-cash return of maybe 8% on a net leased property or 10% on some apartments, we might get those returns in the stock market.

Considering the cap rate or cash-on-cash return alone is misleading when comparing investments like stocks, bonds or savings to real estate. Just looking at the cash-on-cash return, you may overlook many of the benefits of real estate investments, like the power of leverage and inflation. A more complete and informative way to compare different type investments is to consider the financial management rate of return, (FMRR). This method considers; reinvestment of cash flows, mortgage principal reduction, additional capital contributions, revision profits and cost, income and capital gains taxes and inflation.

Once a visiting out-of-town agent, whose son was considering acquisition of a multi-family investment property through our firm, was incensed at the price. She demanded explanation of the value and why her son should settle for an 8% return on his cash and deal with management. We told her we considered and compared the income, expenses and returns by the following methods: G.R.M., C.A.P., I.R.R., as well as the F.M.R.R. approach. We told her we also considered the replacement cost and the sales comparables approach, which all seemed to support the always popular W.A.G. method of valuation. We defined and explained these methods further, but she only wanted to consider the cash-on-cash return, though she enjoyed the W.A.G. valuation method, Wild A?! Guess... She advised her son not to buy. The property sold the next day and the buyer of that particular property ended up with a 51% return over 3 years! She should have looked further than just the cash-on-cash return, and the W.A.G. method.

Let's look at a simple example of just how the inflation factor alone might affect a stock, and a real estate investment differently. Let's assume a \$100,000

stock investment has a good cash-on-cash return of 10% or \$10,000. You are comparing it to a \$100,000 real estate investment that has a low cash-on-cash return of only 5% or \$5,000. If you can get a good 10% cash return on the stocks and only 5% on the real estate, why would you buy the real estate?

Since real estate is such a stable investment, lenders will invest (loan) \$400,000 with you, enabling you to leverage that \$100,000 into a \$500,000 property. Using an average projected 2.5% inflation rate, the real estate value increases by \$12,500, ($\$500,000 \times 2.5\% = \$12,500$). Add the 5% cash on cash return cash flow of \$5,000 and you gain \$17,500!

Your return on the stock investment is 10% or \$10,000, compared to 17.5% or \$17,500 on the real estate investment, and we are not even considering the principal reduction on the loan.

This example is obviously simplified for an easy comparison and we only looked at the inflation factor in the F.M.R.R. The real estate investment provides additional benefits, like; the aforementioned principal reduction on the loan, tax deductions, increasing rents over time, and possibly added value by better management. The real estate investment has another large comparison blue ribbon. The Starker 1031 exchange process. When you make these stock or real estate profits, good old Uncle Sam has his hands out. With the real estate investment, as opposed to the stock investment, you can sell the property, and instead of donating the capital gains tax to Uncle Sam to spend, you can defer and invest this capital gains tax portion for yourself.

Michael Bull, CCIM, CRB, ePro is the managing broker of the Atlanta office of Bull Realty, Inc. and its subsidiaries, a full service commercial and investment real estate firm.

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