AN ANALYSIS OF THE PAST, PRESENT, AND FUTURE OF INVESTING IN RESIDENTIAL REAL ESTATE AND MANAGING THOSE RENTAL PROPERTIES

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of Master of Business Administration

By
Sarah LeeAnn McDonald
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CERTIFICATION OF APPROVAL

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Dr. Jingyun Li, Faculty Advisor
Assistant Professor of Operations Management

Date

Ms. Katrina Kidd, Director
Graduate Business Programs

Date

Dr. Tomas Gomez-Arias, Dean
College of Business Administration

Date

DEDICATION

This project is dedicated to the people who guided my path and had a hand in helping me become the person I am today. To my fiancé and soon-to-be husband, because of you I am a better person. You make me want to strive to be the best version of myself I can possibly be. To my stepfather who encouraged me to chase my dream of going to school and to get an education: you are the reason I am so interested in real estate. To my mom, where I learned what love and compassion are. You are the most kind and caring person I know. To my grandpa, who taught me about honor and loyalty. I will always be proud to be a McDonald. To my grandma, who showed me how to be a strong independent woman: through watching you start and run your own business I gained strength. To my father, who taught me about the value of having good work ethic: you are the reason I am not afraid of hard work and getting my hands dirty.

ACKNOWLEDGEMENTS

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I would also like to give a special thank you to my advisor, Dr. Jingyun (Jenny) Li, for her guidance and valuable assessments of this research project. Her readiness to give her time so kindly has been very much appreciated.

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ABSTRACT

The real estate market can be an unfamiliar area and often even intimidating. It is difficult to know how to find the right resources to search for income properties. The process of deciding which property will yield the best return can be daunting. When receiving advice, it can be difficult to know if the advice is truly good advice. The overall aim of this research project was to explore, analyze, and increase the understanding of investing in real estate. Data were collected through various online sources and compiled into an easily comprehensible format. Insightful understanding by means of detailed research in the planning and searching phase is expected to enhance the outcome of investing in the housing market and increase the likelihood of a positive cash flow. Understanding how various forms of ownership can limit liability exposure and assist in obtaining financing will be beneficial. When investing in real estate it is important learn how tax laws can increase cash flow. Consideration should be given to the risk of owning rental properties and how to manage those properties. It is concluded that investing in real estate can yield greater returns than the stock market in the long term and can prove to be a lucrative investment.

CHAPTER I

INTRODUCTION

Background

As a young girl, about 8 years old, I can remember traveling with my stepfather, who stepped up as my father, to the various properties he owned to collect rents. Collecting rents was not all we were there for. He would have conversations with his tenants to say hello and ask them how they were doing that month. He would make repairs if people had any complaints, and he would be there every month on the first of the month, sometimes before the first of the month if tenants would let him know they had the rents early. He was there every month rain or shine to collect his profits.

Seeing these positive exchanges as a young girl, watching my father happily collect his rents, and seeing the more than comfortable lifestyle he lived was alluring. From a young age I thought investing in real estate would be something I could enjoy just the same as he did. I had years of information and insight into being an investor first hand from him. I saw the good, the bad, and the ugly, but being an investor in real estate is something I have always wanted to be. It is something that has always been on my goals list, just like obtaining a master's degree.

Another fond memory I have is driving around with my father to various properties which were listed for sale and stopping to take a closer look. He would get out of the vehicle and take a look at the structure, the foundation, the neighborhood, and check other factors, to decide if he was interested in putting in an offer even before contacting a real estate agent. Having that type of skill and vision comes with years of experience. He could imagine how to transform a property through a few well-chosen upgrades to increase the value and make money from the deal.

Taking a drive to look at neighborhoods and properties for sale is something that has carried with me into adulthood. I still enjoy driving around and looking at real estate. It is fun to explore properties and dream of the future.

I myself have toured properties and have come close to investing, but in the end realized it was not going to be a wise investment. I was only going to break even and in my opinion that does not prove to be a good investment. To invest in real estate only to wait for the appreciation is not an investment move I would like to make. I believe an investment in real estate should provide positive cash flow from the start, even if the cash flow at first is small.

The idea of investing in real estate is exciting to me because I would be able to bring in extra cash doing something I really enjoy. I would like to have a life of financial freedom and personal fulfillment, and I think this can be achieved through investing in real estate. As I mentioned I have not invested in a rental property yet, but hopefully after learning more about investing in real estate through this project I will feel more equipped to take that first leap.

Why Invest in Residential Real Estate

Why invest in real estate? Within the last 50 years real estate has become a well-liked investment option. There are many benefits to investing in real estate and for many reasons real estate is considered a good investment. With the correct and wisely chosen assets, investors can experience foreseeable cash flow, superior to market returns, tax advantages, and diversification. There is great potential in real estate to build wealth.

A noteworthy advantage of investing in real estate is the capability to produce cash flow. Cash flow from a real estate investment is the net income which is remaining after operating expenses and mortgage payments have been paid. Typically, cash flow increases over the years as the mortgage is paid down and equity is built up. Another reason to invest in real estate is tax breaks and deductions. There are numerous deductions and tax breaks real estate investors can take advantage of that can save money when it comes to filing a tax return. There are certain items an investor can deduct, which are the appropriate costs of holding, operating, and maintaining real estate. One of the costs of owning a rental property which can be deducted is depreciation. The cost of purchasing and improvements on an investment home can be depreciated over its useful life of 27.5 years for residential properties. This depreciation deduction creates a benefit for decades to help lower the taxable income.

Another motive to invest in real estate is the benefit of appreciation. Real estate investors earn their money through rental income and also appreciation. Property values typically increase with time, and with the right investment, a profit can be earned when it comes time to sell. Another option for investors when a property incurs appreciation is to refinance and pull cash out. This cash can be used for repairs, remodeling, or even reinvesting in new properties. The ability to refinance and pull cash out of one investment to purchase another is called leveraging, and I will discuss that next.

A real estate investment allows an individual to build equity which can result in increased wealth. As a property mortgage is paid down, or the property experiences appreciation, or both, equity is increasing. As equity is built, an investor has an increased leverage ability to purchase other homes and thus elevate cash flow and wealth. Real estate leveraging is the use of different financial investments or borrowed capital, also known as debt, to increase the potential return an investment. For example, a 20% down payment for an investment home gets the buyer 100% of the house; this is known as leveraging. Real estate is a physical asset which can serve as a guarantee, so financing is easily obtainable. Another way investors achieve increased cash flow is inflation. Inflation causes rents to rise over time, generating higher cash flow.

Another advantage of real estate investing is the prospect of diversification. Real estate has a small, and at times a negative correlation with other investment classes such as stocks and bonds. This negative correlation can be seen in Figure 1. Carlson explains,

> The relationship is far from stable but this is actually a good thing from a portfolio management perspective because correlations are never going to be stable between asset classes. The fact that the correlations can and will change

can actually benefit investors from a diversification standpoint (Carlson, 2018).

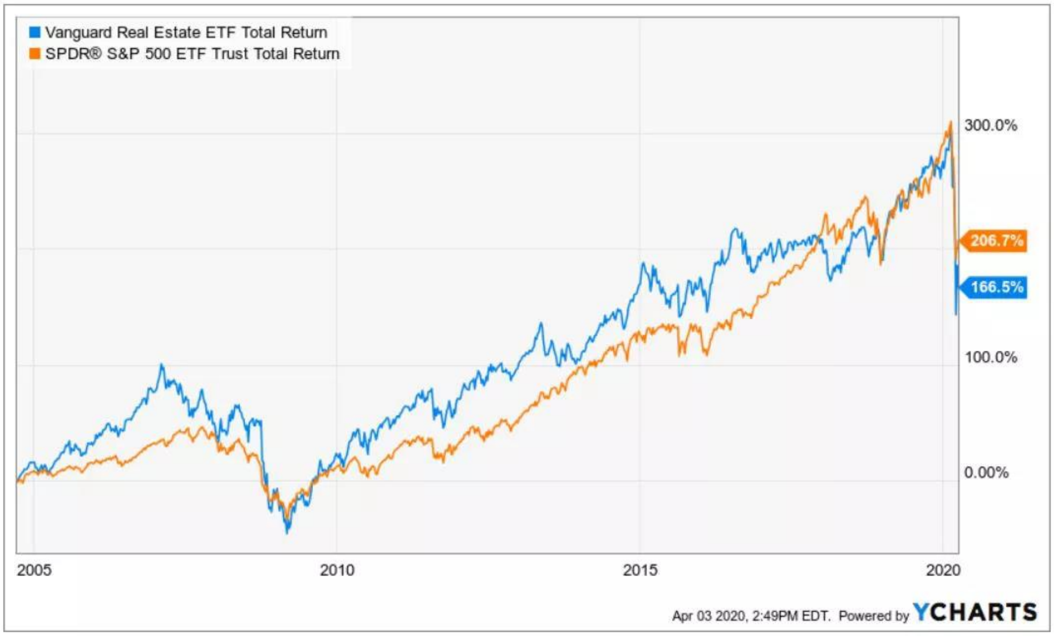


Figure 1. Correlation of real estate to the stock market.

This means incorporating real estate into an investment portfolio of varied assets can decrease portfolio instability. Real estate offers competitive risk-adjusted returns. Of course, real estate returns differ on various features such as location, asset class, and management of the property. Many investors aim to have higher average returns than the S&P 500. The average annual return of real estate over the past 50 years is about 11%. See Figure 2 for the comparison of real estate average returns and stocks average returns. Brad Case explains,

> Real estate trusts have typically outperformed the rest of the stock market over most periods of significant length.…REIT outperformance generally grows as the historical period lengthens: From around half of all relatively short

historical periods (10 years or less) to more than 90% of most historical periods longer than 24 years (Case, 2016).

The comparison of real estate and other investments will also be discussed in greater detail in Chapter V.

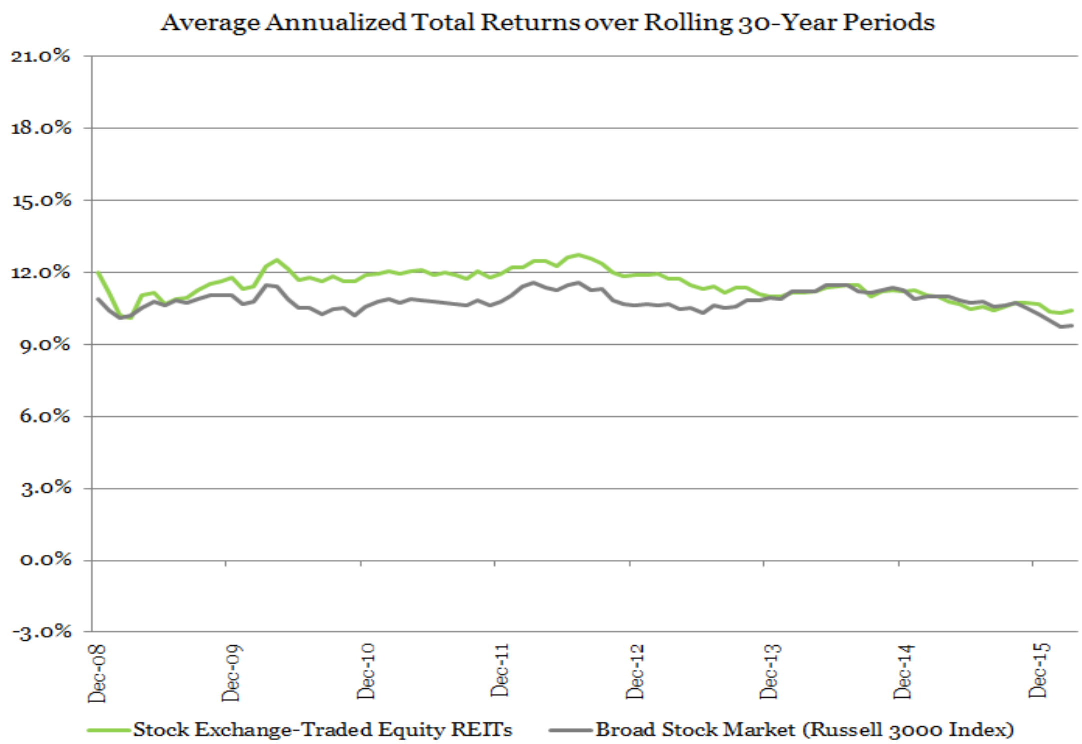


Figure 2. Comparison of average annual total return. (Case, 2016)

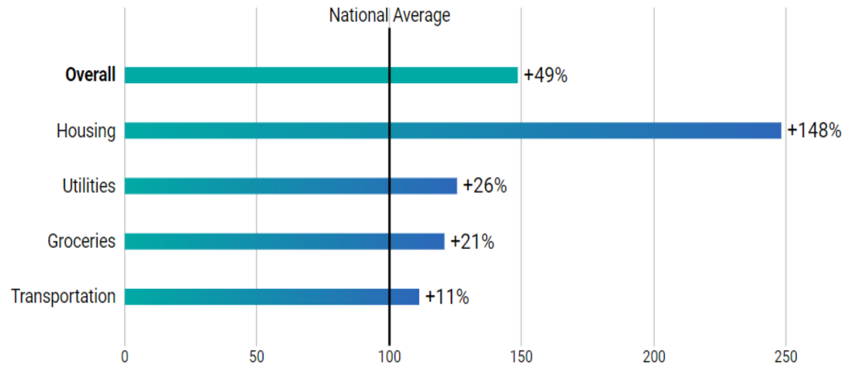
Investing in real estate also provides the ability to hedge inflation. A dollar today will not buy the same value of goods in 10 years. Inflation is a natural occurrence in the market economy, and the ability to hedge inflation in real estate arises from the positive connection between the growth of the economy and the demand for real estate. Inflation occurs in market economies, but investors can plan for inflation by investing in asset classes, such as real estate, that tend to outperform the market during inflationary climates. As economies enlarge, increased demand for real estate drives rents upward, which results in higher capital values.

Real estate is a separate investment class which is easy to grasp and can improve the risk-and-return profile of an investor's portfolio. Even as a standalone investment, real estate offers tax breaks, cash flow, equity building, and the ability to hedge against inflation. Through diversification real estate can lower the unpredictability and enhance a portfolio. After learning all the benefits of investing in real estate who wouldn’t want to invest?

Why Invest in Modesto and Surrounding Communities

Modesto (CA) and the surrounding communities can potentially be a great place to invest for several reasons. The first and most notable is its close proximity to San Jose and San Francisco, two of the country’s most productive housing markets. The Modesto area is a short commute for many individuals who want to rent or buy in that area but continue to work in the Bay Area. According to Marijke Rowland of *The Modesto Bee*, 8.7% of Modesto’s full-time workers travel back and forth daily for work, and in the Stockton-Lodi area 11.2% of the workforce commutes to the Bay Area. The lower cost of living in Modesto and the surrounding areas is attractive, especially to those who continue earning Bay Area wages. See Figure 3 and Figure 4, which compare the cost of living for San Jose and Modesto, respectively.

Cost of Living in San Jose, California by Expense Category

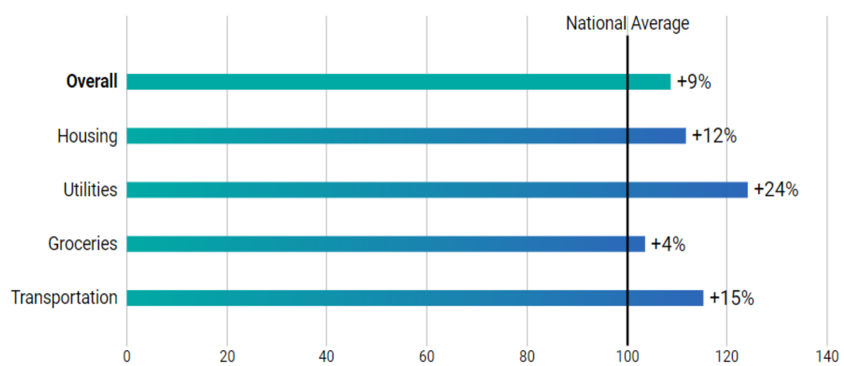


Housing, Utilities & Transportation

San Jose's housing expenses are 148% higher than the national average and the utility prices are 26% higher than the national average. Transportation expenses like bus fares and gas prices are 11% higher than the national average.

Figure 3. Cost of living in San Jose. (Payscale, 2020).

Cost of Living in Modesto, California by Expense Category



Housing, Utilities & Transportation

Modesto's housing expenses are 12% higher than the national average and the utility prices are 24% higher than the national average. Transportation expenses like bus fares and gas prices are 15% higher than the national average.

Figure 4. Cost of living in Modesto. (Payscale, 2020).

The World Population Review (2020) provided some relevant statistics of Modesto for 2020. Modesto is the 17th largest city in California and ranks 101st largest in the United States. The population in 2020 was 218,758 and growing at a rate of 0.86% annually. Since the last census in 2010 Modesto's population has increased 8.75%. The average household income in Modesto is $75,000, and the median rental cost is $1,122 per month. The percentage of people who rent their home compared to who purchase is displayed in Figure 5.

Figure 5. Modesto renter versus owner occupied by household type. (World Population Review, 2020).

Housing prices in the Modesto areas have not appreciated as quickly as in the national housing market. The prices have actually remained somewhat stagnant. This could have a favorable outcome for both buyers and sellers. Increases in home values are still expected to occur, which means it is not too late for investors to invest in those areas and realize the benefits of appreciation. Along with the increase in appreciation that is expected to be realized, rent prices have steadily been on the rise. Investors can expect to see higher returns on their investment from appreciation and rent. See Figure 6 for the increase in rent prices.

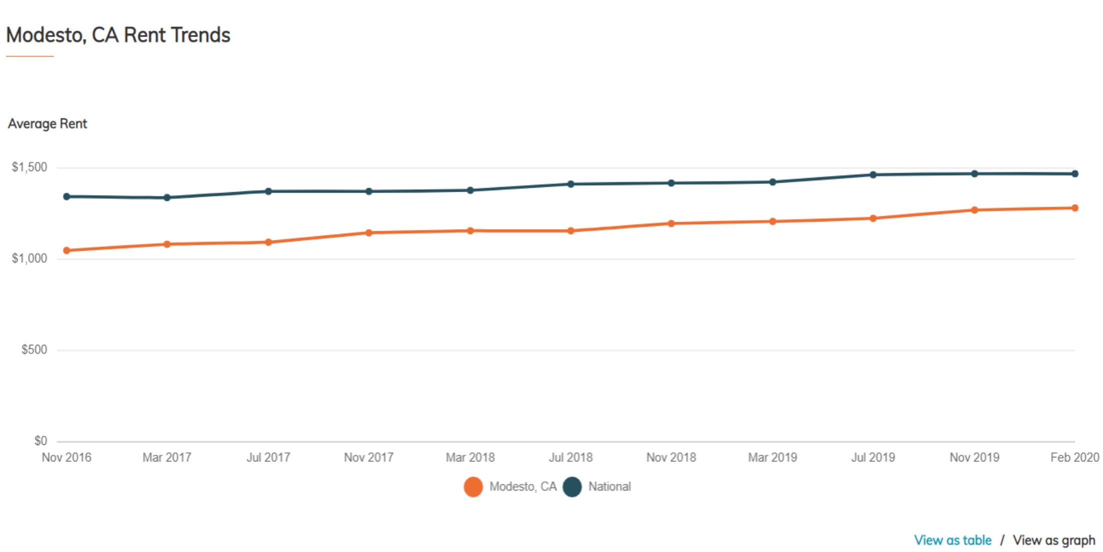


Figure 6. Modesto, CA rent trends. (RentCafe, 2020).

The greater Modesto area offers diverse investment options. Single family homes have always been a popular investment and the area has a large supply of these homes. The area also offers the opportunity to invest in multiunit properties. Investing in multiunit properties will help to diversify real estate investments. Another attractive reason to invest in Modesto and surrounding areas is that vacancy rates are extremely low (see Figure 7). Vacancy rates are much lower than the national average. With investment property, if there is high renter turnover the costs to continually prepare a rental to rent can be high. For example, if the landlord needs to clean or even replace the carpets, or if the inside needs painting the due to abuse of the home by the tenant, this can eat into profits.

Historical Rental Vacancy Rate data for Modesto

Date	US	California	Modesto, CA
2017	6.18%	3.49%	1.86%
2016	5.89%	3.31%	1.92%
2015	5.85%	3.33%	2.98%
2014	6.32%	3.90%	4.47%
2013	6.49%	4.22%	7.53%
2012	6.77%	4.51%	4.25%
2011	7.40%	4.94%	5.22%
2010	8.17%	5.86%	6.17%
2009	8.43%	5.76%	8.17%
2008	7.86%	4.71%	5.64%
2007	7.87%	4.72%	7.10%
2006	7.70%	4.67%	4.46%

Figure 7. Historical rental vacancy rate data for Modesto. (Department of Numbers, 2017).

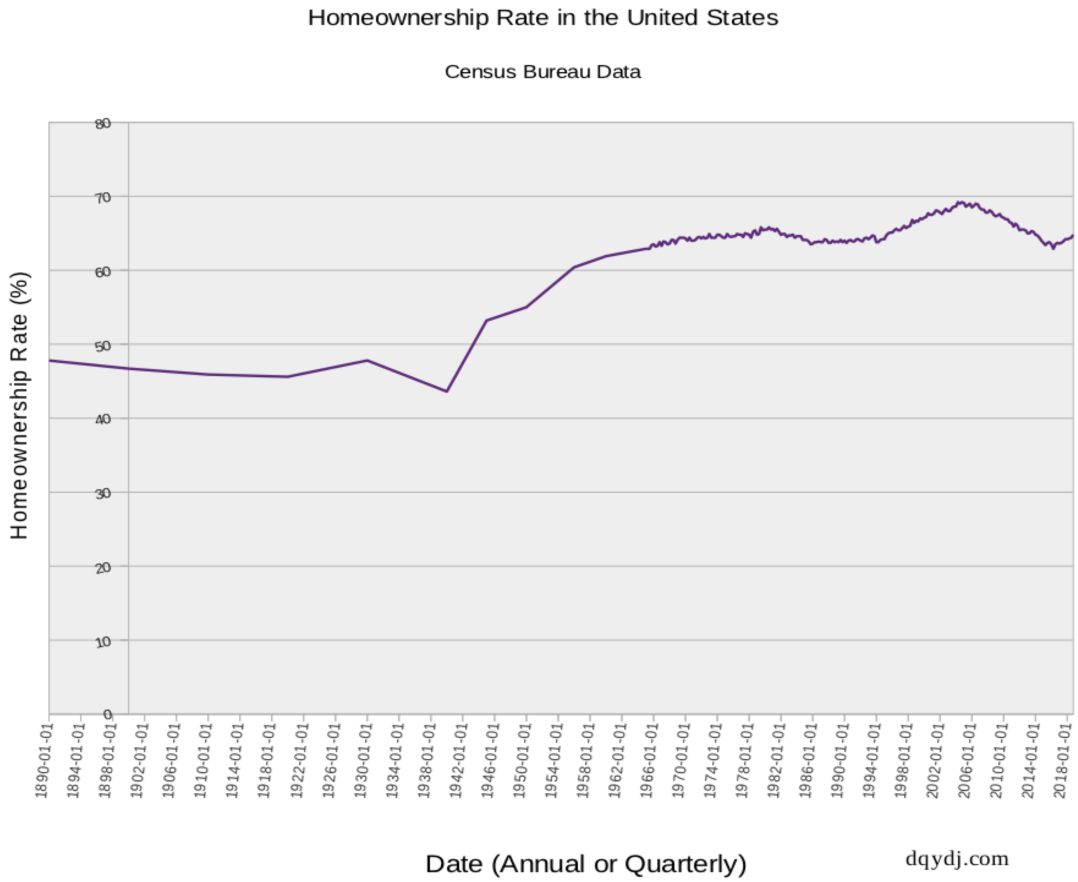
CHAPTER II

REAL ESTATE MARKET

History of Real Estate

The idea of owning land is engrained in both the national culture and the U.S. Constitution. In its Preamble, the Constitution endorses freedom by affirming people have a right to secure the blessings of liberty. Home ownership is something everyone hopes to achieve and is expected as part of the American Dream. The American Dream has transformed throughout the course of history, but two things have always remained, home ownership and upward movement. The American Dream is deeply rooted in the Declaration of Independence, with phrases such as, "all men are created equal" and have the right to "life, liberty, and the pursuit of happiness." For most Americans, owning a home implies success, freedom, and wealth.

For the longest time, owning a home was the exception rather than the rule. Farmers were the only ones likely to own land and a house during the early years of the U.S. Change occurred with the Industrial Revolution, and homeownership became more common for people living in urban areas. According to PK in the article, *Historical Homeownership Rate in the United States, 1890-Present,* less than half of all Americans owned their homes until the late 1940s. In the 1940s, 43.6% of Americans owned their home, in the 1950s this number increased to 55%; in 2010 the home ownership rate jumped to 66.5%. Surprisingly, in 2018 the rate decreased to 64.2% (see Figure 8).



Historical Homeownership Rate Data Points, for 1890 through 1970

Date	Homeownership
01/01/1970	62.90%
01/01/1960	61.90%
01/01/1956	60.40%
01/01/1950	55.00%
01/01/1945	53.20%
01/01/1940	43.60%
01/01/1930	47.80%
01/01/1920	45.60%
01/01/1910	45.90%
01/01/1900	46.70%
01/01/1890	47.80%

Figure 8. Home ownership rate in the United States. (PK, 2020).

During the 1800s, most Americans did not have the means to purchase a house. They had no large sum of money for the purchase, and banks would not lend money to average people to purchase homes. It was not until the U.S. banking system was stabilized following the National Bank Acts of the late 1860s that mortgages become common. After this reform, banks experimented with lending money for homes, and by the 1890s, mortgages were widespread across the U.S. A mortgage during that time was not like the mortgages we know today.

A typical mortgage in the early 1900s would have roughly a 5-year amortization period and require a down payment of 50%. It was designed with interest-only payments and a large balloon payment for the entire principal at the end of 5 years. These early mortgages were working well until the Great Depression. When the Great Depression hit, banks had no money to lend, and the average borrower had no cash either. As a result, people could no longer afford to purchase homes; they were struggling just to put food on the table.

The economic richness of the 1920s created a huge surge in real estate housing. But by the mid-1930s, 16 million people were unemployed and the demand for real estate of every type declined. In order to stabilize the housing market, the U.S. government, under the leadership of President Franklin D. Roosevelt, created organizations to assist during the crisis. These organizations were the Home Owner's Loan Corporation (HOLC) in 1933, the Federal Housing Administration (FHA) in 1934, and the Federal National Mortgage Association (FNMA), which is now Fannie Mae, in 1938. The purpose of HOLC was to refinance home mortgages that were in default to prevent foreclosure. The FHA’s purpose was to set standards for construction and underwriting, and to insure loans made by banks and other private lenders to build homes. The goals of FHA are to improve housing standards and conditions, to provide an acceptable home financing system through insurance of mortgage loans, and also to stabilize the mortgage market. These institutions helped to end the housing market crash, and homeownership slowly increased and reached new heights.

The face of the housing industry and the American economy changed with the introduction of the G.I. Bill of 1944. This bill provided subsidized mortgages for World War II veterans. The GI Bill’s mortgage subsidies led to an increased demand for housing and the development of suburbs. In the 20 years following World War II, 20% of all single-family homes built were financed with the help from the GI Bill’s loan guarantee program, signifying the emergence of a new middle class.

As more Americans began buying houses the profession of realtor was born. The home buying process became more complicated and the job of the realtor was to help simplify the process. The term Realtor was coined in 1916 by The National Association of Real Estate Boards. The housing market was prosperous during the 1940s and 1950s, and so was the real estate profession. As mentioned earlier, more than half of all Americans owned their homes by 1950, for the first time in American history.

As demand for housing increased, the prices did as well. With higher home prices and ownership rates came higher mortgage amounts. In the previous 50 years, long-term mortgages with large balances became more normal to the point that large balances were customary. Between 1949 and the turn of the 21st century, the ratio of mortgage debt associated to gross income of the average household rose from 20% to 73%. The increase in mortgage sizes can be attributed to the increase in housing sizes. According to the U.S. Census Bureau (2019), the median size for a new home built in 1973 was 1,525 sq. ft. By 2016, it had jumped to 2,422 sq. ft. What is even more interesting about this is that while home sizes were expanding, families were reducing in size. The average household was 2.9 people in 1973, and 2.5 in 2016.

In the 1980s, cable television aired the first of numerous shows glamorizing home improvement. Since then, the entertainment industry has taken the enticement of reality T.V., combined it with the allure of investing in real estate, and ran with it. The flood in programs based on repairing homes, flipping houses, and DIY projects inspired thousands of real estate investments. The American Dream of investment success and financial freedom became real and obtaining a property that proved to be a profitable investment became an attainable goal for the average American.

In 1970, the average price for a house in the U.S. was about $25,000. A decade later, that price had doubled to $50,000. In 2000, the medium price averaged $125,000. This is 5 times the home price in 1970. Around the year 2000, a massive pricing bubble began to occur. This was followed by the disastrous housing market crash and economic downturn of 2008. There is a long record of bubbles and bubble bursts in the history of real estate.

Throughout 2008, with each downturn of the economy the Federal Reserve decreased interest rates. With mortgage rates continuing to decline, real estate investing began to have an appeal to those interested in putting their money into an investment other than the stock market. Real estate investing might have started as a fad from cable T.V. shows, but the housing crash was when real estate investing really began to take off. The 2008 crash caused a large supply of distressed properties and a large number of possible tenants as displaced homeowners were forced to lease. With mortgage rates low, real estate investing continued to be a growing industry, and it became an achievable goal for average homeowners who were stable enough financially or had built up equity in their primary residence to secure financing. Real estate investing became an option for ordinary people who were flipping houses or adding the title of landlord to their job description.

Real Estate Cycles

The real estate market, much like the stock market or commodities market, incurs periods of boom and bust. All these markets have alternate periods of high and low levels of economic activity in their business cycles. The time involved to invest in real estate can differ from other investments such as stocks, bonds, and commodities. It takes substantially more time, from start to finish, for an investment in real estate to yield results compared to an investment in the stock market. Real estate properties may be subject to real estate cycles caused by external circumstances. Some of these issues are vacancy factors, loss of major tenants, changes from renting to ownership, shifts in consumer markets, and an increase in competing properties.

The law of supply and demand will cause fluctuations in housing prices and transaction rates, the so-called cycles. It is beneficial for investors to have an understanding of historical real estate cycles which can assist them in the decision-making process of whether to buy or sell real estate. An investor must be mindful of the timing of the cycle. Investors must know at what point in the cycle to make the decision to buy or sell. Depending where in the cycle the market is and what decision the investor makes can lead to success or failure. For example, if the investor's timing is wrong and she enters into a cycle at the wrong time and acquires a property above the fair value, a financial disaster on that property may be looming.

The phases of the real estate cycle are similar to the phases of a business cycle. The four real estate phases are expansion, contraction, recession, and recovery.

Expansion Period

The expansion period would see construction of new projects, rent amount increases, and vacancies tending to decline. The demand for rentals begins to exceed the available supply. As expansion continues, capitalization rates will begin to decline as more investors look to acquire property. The capitalization rate is a real estate valuation used to analyze different real estate investments. The capitalization rate is a formula which compares the ratio of a rental property's net operating income (NOI) to its purchase price. As a result of the demand and the preference of investors to enter the market, prices of real property start to rise. As prices rise, this becomes a seller's market.

Contraction Period

In this phase there will be substantial new construction and the result is excess property along with increasing competition. As a result of the oversupply of property, demand declines, vacancies begin to rise, and rents will decrease. In this phase investors tend to withdraw from purchasing property. If the oversupply of properties continues, capitalization rates will rise and if the supply exceeds the demand for too long a period of time, a recession may follow.

Recession

A recession tends to follow a lengthy contraction phase. In this phase rents continue to decline sharply and vacancies continue to increase. Investors will have no desire to buy real estate. Capitalization rates will increase leading to lower valuation of real estate. Borrowers will begin to default on their loans and be forced into foreclosure.

Recovery

When the market begins to recover, vacancies tend to decline, there is very little or even no new construction, and rent growth tends to be below inflation. Also, capitalization rates are stagnant but high.

There have been numerous real estate cycles over many periods of time. Real estate cycles date as far back as 1818 and the length of cycles has varied from 6 years to as long as 48 years (1925-1973).

Major Tax Legislation and the Effect on Real Estate

As mentioned previously, there are many economic factors such as rising interest rates, supply and demand, tight lending policies, and others which can contribute to real estate failures or success. Another economic factor is the changes in tax laws which may have a detrimental or beneficial impact on real estate investing. There have been many tax law changes through the years but two had a significant impact on the real estate market, the tax acts of 1981 and 2017.

The Economic Recovery Tax Act of 1981 (ERTA) was an amendment to the Internal Revenue Code of 1954 to encourage economic growth through reductions in individual income tax rates, the expensing of depreciable property, and incentives for small businesses. With this act there was a decrease of the marginal income taxes rates by a shocking 23% over 3 years, causing the top tax rates to fall from 70% to 50%, and the lowest tax rates to fall from 14% to a meager 11%.

In addition to the marginal tax rate decrease, the capital gains tax was reduced from 28% to 20%, which provided an added tax benefit to real estate investors when the property was sold. The act also introduced the Accelerated Cost Recovery System (ACRS). ACRS allowed investors to depreciate real property over 15 years instead of 40 years as required previously. In addition, investors were able to use the accelerated 175% declining-balance method instead of the straight-line method, which caused an increase in tax deductions in the early years. These new provisions of ERTA allowed for an increased after-tax return on the investment, and also had the effect of deferring taxes and recapturing any taxable gain with lower tax rates. The tax benefits of these changes will be discussed in the tax advantages section of Chapter V.

The 2017 Tax Cut and Jobs Act introduced many tax-increasing measures. This act includes a 37% maximum federal tax rate for individuals versus the 21% maximum tax rate on C corporations. Also, the 3.8% net investment income tax (NIIT) of the tax section 1411 can impact an individual's real estate capital gains, rental income, and other types of income but the tax is not imposed on C corporations. The NIIT applies to certain net investment income of individuals, estates, and trusts that have income above statutory threshold amounts.

The 2017 Tax Act eliminated the option for individuals, estates, and trusts to carry back net operating losses (NOL). Most taxpayers can only carry NOLs arising after 2017 to a later year. The NOL deduction has a limitation that it cannot exceed 80% of taxable income for losses arising in tax years beginning after 2017. Taxable income for this purpose is determined without any NOL deduction.

It is important for investors to pay attention to tax laws which may have an impact on real estate investing. If an investor does not follow changing tax legislation there can be a negative impact to the bottom line. If they do not understand tax laws or have time to follow the changes it would be wise to enlist the help of a tax accountant and possibly work on tax planning.

The Causes and Impact of the Great Recession on Residential Real Estate

Many factors directly and indirectly caused the Recession of 2007-2008, which is commonly referred to as the Great Recession. Experts have different views as to the specific causes. The crisis resulted from a combination of complex factors, but most notable were the easy credit conditions during 2002-2008. This short, 6-year period encouraged high-risk lending and borrowing practices, predatory lending, and subprime lending.

Many institutions lowered credit standards to continue feeding the global demand for mortgage securities, generating huge profits that their investors shared. Predatory lending includes any corrupt actions carried out by a lender to entice, induce, and assist a borrower in taking a loan that carries high fees, a high-interest rate, strips the borrower of equity, or places the borrower in a lower credit-rated loan to the benefit of the lender. A subprime loan is a type of loan that is accessible at an interest rate above the prime rate to persons who do not meet the requirements for prime-rate loans. More often than not, subprime borrowers have been denied by traditional lenders because of their poor credit score, or there may be elements that conclude there is a possibility they may default on the mortgage repayment. Even worse, U.S. households often had adjustable rate mortgages, which had lower initial interest rates and payments which later rose as the Federal Reserve raised the prime rate.

In addition to considering higher-risk borrowers, lenders offered increasingly risky loan options and borrowing incentives. Mortgage underwriting standards declined gradually during the boom period, particularly from 2004 to 2007. Lenders began using automated loan approvals which allowed loans to be made without appropriate review and documentation. According to Lynnley Browning, in 2007, 40% of all subprime loans resulted from automated underwriting. Mortgage brokers did not do enough to examine whether borrowers could repay, and mortgage fraud by lenders and borrowers increased enormously (Browning, 2007).

Several financial market factors created a perfect storm for the housing market crisis. Financial product innovation occurs when financial products are designed to achieve particular client objectives, such as offsetting a particular risk exposure or assisting with obtaining financing. Examples of these innovations are the adjustable rate mortgage and the bundling of subprime mortgages into mortgage backed securities (MBS). Credit rating agencies have been criticized for having given investment-grade ratings to MBSs based on risky subprime mortgage loans. These high ratings enabled the MBS to be sold to investors, and in turn financing the housing boom. It was reported to the U.S. Department of Housing and Urban Development, that an estimated $3.2 trillion in loans were made to homeowners with bad credit and undocumented incomes between 2002 and 2007 (Smith, 2007).

Banks also discovered a way to move significant amounts of assets and liabilities off their balance sheets. This was referred to as off-balance-sheet financing. Complex financing structures called structured investment vehicles (SIV) enabled banks to move assets and liabilities, including unsold collateralized debt obligations (CDOs), off their books. This had the effect of helping the banks maintain regulatory minimum capital ratios, allowing them to continue lending and earning additional fees. Off-balance-sheet financing also made firms look less leveraged and enabled them to borrow at lower rates. Certain financial innovations may also have the effect of circumventing regulation. For example, off-balance-sheet financing that affects the leverage or capital cushion reported by major banks allowed them to meet regulatory requirements. Off-balance-sheet vehicles were a way for banks to find a way around regulation.

The government had a hand in the 2007-2008 housing crisis as well. Governmental policies failed to regulate nondepository banking. Nondepository banking is referred to as the shadow banking system. It refers to a collection of nonbank financial intermediaries that provide services similar to traditional commercial banks but outside normal banking regulations. The Shadow banking system grew to exceed the size of the depository system but was not subject to the same requirements and protections. The shadow banking system expanded to rival and perhaps even surpassed conventional banking in importance, and politicians and government officials did not realize they were reproducing the situation of economic weakness which caused the Great Depression. The government should have addressed the situation by extending the same financial regulations to these new institutions.

By September 2008, average U.S. housing prices had deteriorated by over 20% from their highest in mid-2006. Easy credit and the false certainty that house prices would never fall had tempted many subprime borrowers to sign for an adjustable rate mortgage. These mortgage types attracted borrowers with interest rates below market for some initial prearranged period, followed by market interest rates for the rest of the financing period. As the market rate increased so did the mortgage payment. Borrowers who could not make the new increased payments once the initial grace period ended would try to refinance their mortgages. When the price of homes began to decline in many parts of the United States refinancing became more challenging. Borrowers who were unsuccessful in refinancing and not able to avoid higher monthly payments had no choice but to default. During 2007, lenders had begun foreclosure proceedings on nearly 1.3 million properties, a 79% increase over 2006. This increased to 2.3 million in 2008, an 81% increase compared to 2007. As of August 2008, 9.2% of all outstanding mortgages were either delinquent or in foreclosure.

A key theme of the crisis is that many large financial institutions did not have a sufficient financial cushion to absorb the losses or to support the commitments made to others. Government programs were incompetent and private efforts were not much better. To summarize this snowball of a crisis, many institutions lowered credit standards to continue feeding the global demand for mortgage securities, banks filled their balance sheets with subprime mortgages, and loans were generated without income verification standards. Along came Wall Street, purchasing huge mortgage portfolios, which were then repackaged into mortgage backed securities and sold to investors. While sharing large profits, investors were exposed to high risk. Over a short period, housing debt levels rose sharply. Not only was new debt created, but many households refinanced their homes, extracting large amounts of equity. The creation of these new and complex financial products proved to be a major regulatory failure.

The Impact of COVID-19 on the Housing Market

Before the COVID-19 pandemic, the most significant slump in the real estate market occurred during the Great Recession. The full extent of the coronavirus crisis has yet to be seen. Currently, the country is experiencing closures of various businesses, schools, sports, and restaurants. Societies are social distancing and the number of people who have filed for unemployment is staggering. It is likely that the number of home sales will decline. While that does not automatically mean home prices will follow suit, it does mean the way people buy and sell homes will undergo changes, at least in the near future. COVID-19 has changed the way all organizations and establishments operate; why would the way buying and selling homes be any different?

While it is too early to determine the full impact COVID-19 will have on real estate there are some potential impacts which buyers and sellers may see over the near term. Financial forecasts have been downgraded, but few economists are uttering the term recession yet. Growth is expected to be slower but the economy is still expected to grow. Before COVID-19, mortgage rates were low and rates have decreased slightly during COVID-19. Rates are expected to remain low and may even decrease slightly once again. It would not be surprising if the Federal Reserve reduced the prime rate to counteract the negative impacts on financial markets. The construction of new homes could further decline, putting pressure on the already tight supply of homes. Many materials and resources are from Asian countries including China. COVID-19 has disrupted many supply chains caused the costs of materials to increase and supplies to become limited. The compounding effects of low rates and slowed construction of new homes could drive upward pressure on home prices. While these are merely predictions of the impact of COVID-19 this could very well be the reality in a year's time.

Trends of Rental Markets

During this past decade there has been a shift from home ownership to renting. Due to the recession many families were forced to rent out of necessity. The recession, combined with changing attitudes toward homeownership, led to a rise in the number of renters. According to Diana Olick of CNBC (2019), rental demand in the second quarter of 2019 has increased by 11% from a year ago.

Another interesting trend is that the participation of first-time home buyers has declined. Kamran Rosen explains, “The National Association of Realtors report shows that first-time homeowners make up 32% of all buyers, compared with a historical average of 40%. That is the lowest percentage since 1987” (Rosen, 2016). The decline is attributed to a handful of reasons, including underemployment, repaying of student debt, struggling to save for a down payment, high price of homes, and Millennials holding off on marrying and having children. Some experts warn that the homeownership rate will continue to decrease. A strong majority of current renters under the age of 34 say they want to own a home in the future. First-time home buyers have remained discouraged in today's tough market of swiftly rising home prices and insufficient supply levels at affordable prices.

Thirty-five years ago, the housing market looked drastically different, with the idea of the internet nowhere to be found. Now, buyers' using the internet to search for houses has been on an upward trend. In 1995 only 2% of buyers searched for homes on the internet; in 2005 that number jumped to 75%, and now it is 90%. Even with the increase of people searching for homes on the internet buyers are still using realtors to complete the home buying process. This means the internet is not replacing real estate agents, but instead simplifying the buying and selling process.

Over the years there has been a downward trend of down payments. In 1989, the average first-time home buyer financed a mortgage with a 10% down payment, and repeat buyers on average financed their home with a 23% down payment. In 2016, those percentages dropped to 6% and 13%, respectively. This decline in down payment is largely due to the higher cost of purchasing a home and the difficulty in saving for a down payment.

As inventory of homes has become insufficient for the demand the search for a home is taking longer. Until 2007, an average buyer would search for a home for 7 weeks, but now that time is up to 10 weeks. Inadequate supply levels have forced buyers to act quickly if they want to purchase a home.

Current State of the Market

Rounding out 2019, house prices continued to rise but at a much slower pace than had been seen in the past 6 years. After 6 years of strong growth in appreciation the housing market is finally seeing a slowdown. There continues to be high demand for homes, but not enough supply listed on the market. Construction has also increased due to increased demand and lower interest rates. The housing market is expected to continue to slow in the coming years.

The first quarter of 2020 was identical to the fourth quarter of 2019. Appreciation is stagnant and inventory is low. The American Enterprise Institute provided several statistics in its National Housing Market Indicators report. House price appreciation from a year ago was up 4.8%. This is a measure of the price today compared to a year ago. The months' supply is a measure of the number of months it would take to sell the existing home inventory at the current sales price, and that is sitting at 3.5 months. That is an indicator of the low inventory available on the market. The new construction share of sales is 11.4%. This measures the share of new construction sales as a percentage of all home sales.

Currently the housing market is a strong seller's market due to the supply of homes. The supply is low with only 3.5 months available, and this has remained unchanged from a year ago. There has not been any significant change in the housing market in the past year. Everything seems to be holding steady with a slight uptick in some areas. Many people are unsure of what is to come in the future and are sitting tight on their investments. Due to COVID-19 many homeowners and investors are feeling anxious because they are not sure of how the pandemic will affect them and their cash flow. Homeowners are feeling unsure how will they pay for their mortgages if they lose their jobs.

CHAPTER III

CHOOSING A PROPERTY

Things Investors Should Know

Investment properties can be very rewarding if investors make the right choices. However, real estate is a tough business and incorrect moves and choices can really cut into profits. That is why it is important for investors to do detailed research before they proceed so they can be on top of all the pros and cons of real estate investing. It is a good idea for them to do some homework on their own before bringing a realtor into the equation. Sometimes realtors have a tendency to pressure clients to buy when the property may not be exactly what they are looking for. When researching it is a good idea for investors to start thinking about exactly what they want. Some items to think about and research are the type of property, location, size, amenities, etc. There are several significant items to consider when shopping for an income property.

The neighborhood an investor is going to buy in is of course very important. The neighborhood investors buy into will determine the types of tenants who will want to rent the property. This could also have an effect on the vacancy rate and having vacancy can reduce the overall profit. For example, if a property is purchased in a college town there may be mostly college students who want to rent. An investor needs to consider college students may be having parties on their property and causing damage which could result in an increase in insurance costs. Also during the summer they may experience vacancies. Consideration should also be given to homeowner's associations (HOA). If an investor does not do their homework and discovers they are not able to turn their property into a rental they may have to turn around and sell the property and may take a loss. Also, some towns may try to prevent rental conversion by imposing excessive permit fees and layering on regulation.

Property taxes are another item to consider. It is a good idea to talk to the local assessment office which should have all the tax information on file, or to talk to property owners in the community. Property taxes can vary widely across the targeted areas and these costs need to be factored into the amount of cash flow expected. High property taxes may not necessarily be a bad thing in a good neighborhood, where long-term tenants are anticipated. On the flip side, unappealing locations can also have high property taxes and may experience high tenant turnover. It is also important to research if property taxes are expected to increase in the foreseeable future. A city or town in monetary distress may increase taxes over what a property owner can ideally charge in rent thus creating a loss for the landlord. A well-chosen property today might not be affordable tomorrow. For example, if the property taxes increase the current rent amount may not be enough to cover the increase. It would be wise for an investor to prepare a 5-year plan of where the area is headed.

Of course, schools and crime are always high on the list of items to research. People are extremely concerned for their children to be safe and have a good education. If an investor is looking into purchasing a single-family home it is a good idea to consider the local schools. Naturally an investor's priority is the monthly cash flow, but the whole worth of the rental property should be considered if the investment is ever to be sold. If the area has no quality local schools the selling price can be affected. In order to locate information about crime in the area it is a good idea to speak to local law enforcement, or the public library should have accurate, up-to-date crime data. Another way to find out about crime is to talk to the neighbors. It is also important to find out if crime is on the rise or if it is declining.

An investor should also consider the number of listings in the area and the number of vacancies. High vacancy rates can cause property owners to lower the rents in order to lure renters. An investor may sometimes be forced to lower rents below the mortgage payment in order to incur less of a negative cash flow. The opposite is true of low vacancy rates. A landlord can raise rents and increase cash flow. When neighborhoods have a high number of listings or vacancies it could signal the area is declining and crime is on the rise. It could also signal a seasonal cycle, so it is important to pay attention to these rates. Another figure to have an understanding of is the area's average rent. This is where an investor's cash flow is derived from so it is important to do the proper research. The average rent for the area should be sufficient to cover the mortgage payment, taxes, insurance, repairs, and various expenses which may arise.

When an investor is considering buying a rental property the operating expenses should be estimated. It is important to estimate the costs of operating a rental property because the costs incurred have a significant effect on the return on investment. When preparing an estimate of the operating expenses, items to include are insurance, property taxes, property management fees, HOA fees, lawn maintenance, general maintenance fees, and all other costs except the mortgage. As a broad range the amount spent on operating expenses typically varies from 35% to 80% of the gross income, and this varies depending on the type of rental property. Many factors can impact the amount of costs such as the type of rental property, condition, age, and size. As an example, if an investor collects $1,500 per month on a rental property, and the operating expenses are $500 per month, the percentage of operating expenses would be 33.3% calculated as $500/$1,500. Keep in mind this does not include the mortgage payment. The maintenance and miscellaneous fees are the hardest costs to estimate. As general rule these costs are 1% of the property value per year. For a property valued at $220,000 the estimated maintenance costs would be $2,200 per year or $183.33 per month. Property taxes are one of the easiest costs to estimate. The amount paid in property taxes is the property's tax assessed value multiplied by the tax rate which is generally 1%. For a property with an assessed value of $220,000 the property taxes would be estimated at $2,200 per year. If a property has HOA fees these are included as a monthly figure in the information for the listing. The insurance amount would be best determined by contacting an insurance agent. If an investor decides to hire a property management company to maintain the rental property, these fees typically range from 6% to 8% of the rent price. With the estimated operating expenses penciled out an investor will be closer to making an informed decision to purchase a rental property or to pass on it.

Other items to consider are the job market, amenities, and future development. A neighborhood with rising employment opportunities is likely to attract more residents. Neighborhoods with businesses which are seen as promising are likely to increase property values. Tenants prefer to live in areas which offer amenities. It is a good idea to tour the neighborhood for parks, gyms, restaurants, public transportation, and so forth. Those types of amenities offer a good quality of life to tenants. An area which has construction or planned construction is probably going to have growth. This could be beneficial for a piece of property, or it could create competition with the property.

Supply and Demand

Real estate, like other tangible assets, is subject to supply and demand. When the demand for housing is high, but supply is low, prices will usually rise. In the current market, demand for homes is high and available inventory is low. On the contrary, when demand is low and supply is high, this is a buyers' market and prices normally will decline.

The theory of supply and demand is one of the most basic principles of economics. Supply and demand is not easy to measure in the real estate market. Real estate transactions take a long time to complete. A factor which affects the demand is lower interest rates. When interest rates are low, people are willing to take on more debt because the payments are not as high had the interest rates been higher. People may be more willing to finance the purchase of a home because once again the interest payments are not as burdensome as if the rates were higher. If buyers are flooding the market due to low rates, obviously the demand is increasing.

Home supply is in a constant state of flux. People put their houses up for sale for various reasons such as moving, a need to downsize or make room for a growing family, job relocation, and many other reasons. Also, there may be an increase in new home development which adds to the supply.

Location, Location, Location

Everyone has heard the motto “location, location, location.” The reason everyone is familiar with this saying is because it is true. This slogan can have different meaning to different people. The best location is relative to the reason for purchasing a property. If an investor is looking to retire and enjoy her golden years, then an ideal location for that investor may be on a beach in Florida. However, if an individual is looking for an investment property, an expensive home in the Florida Keys might not be the best investment.

A home located within a city or a town can significantly affect the price of the home. For example, in a city such as San Francisco there is no land to build on. That area is already highly developed so the price tag there is much greater than in cities and towns which have room to expand.

As mentioned earlier, the neighborhood is a huge factor in the location. Great neighborhoods to invest in will offer things such as accessibility, appearance, and amenities. A great location will be in a neighborhood that is situated near major routes and has more than one point of entry. Commuting to work is a large portion of people's day, so to live where there is easy access to major roads is very desirable. Consider people who live in Modesto and commute to the Bay Area. The most highly sought after areas have easy access to Highway 99. Amenities within the area are equally important. When areas have grocery stores, restaurants, public transportation, and schools, people will pay a higher price for rent.

Another item to consider is where exactly the lot is located. If it is located near a busy road or highway the purchase price will probably be lower, as will the average rate for rent in that area. If a property is located near a grocery store or gas station the amount of traffic will increase and parked cars around the property will increase. A house located in a court or cul-de-sac with less traffic, or a house with a nice view will more than likely bring increased rent income, and when it comes time to sell will have a higher price tag.

The location options will be dependent on whether an investor intends to actively manage the property or enlist the help of someone to do it for them. If investors intend to manage it themselves, they do not want to invest in an area that is far from where they reside. If property management is going to be hired to look after it, then proximity becomes less of an issue.

CHAPTER IV

PURCHASING A PROPERTY

Forms of Ownership

When purchasing rental properties, the form of ownership is typically one of the first choices made and will have substantial significance. The selection of the ownership type can affect present and future subsequent events which can vary when acquiring and selling real estate. The selected form of ownership will determine exposure to legal liability for the owner and will also influence tax ramifications. If the improper form of entity is chosen, the investor could encounter situations generating personal liability, tax liability, or both. This section explains some of the numerous types of ownership, and also their rewards and drawbacks.

Some forms of ownership are Limited Partnerships (LPs), Limited Liability Companies (LLCs), Tenancies in Common (TICs), Joint Ventures (JVs), Trusts, and Subchapter S Corporations. For the purposes of the investment ownership envisioned for this report, the discussion will cover sole proprietorship, partnership, and limited liability companies.

The forms of ownership for an individual are a sole proprietorship or a single-member LLC. Individual ownership is the easiest form of ownership and the least costly. This type is a quick and easy way to initiate possession of real estate, but there is exposure to unlimited liability which is an important financial risk. Vigilant supervision and adequate liability insurance coverage can alleviate the financial consequences, but situations may arise where unforeseen events can produce financial consequences where personal assets are vulnerable. To limit exposure of liability, adequate insurance should be obtained but there are situations where insurance coverage may not suffice. Due to the ease and exposure of this type of ownership it should not be considered when acquiring real estate.

The tax implications of a sole individual ownership represent the simplest form of reporting income and expenses. An individual owner is not required to file separate business tax returns, which is not the case for partnerships or corporate tax returns. All revenue and expenditures are reported within the individual tax return. An investor should also consider their ability to attract capital or leverage. A sole proprietor may not have the capability to attract capital as other forms, such as a partnership or LLC may have.

A single-member LLC is also known as a disregarded entity. By using this type of ownership, the dilemmas of individual proprietorship will be alleviated and the exposure to legal liability, which is typically present when real estate is owned in the individual’s name, should be minimized. An LLC is treated as a pass-through entity when filing tax returns. If the LLC has only one member, the owner will report revenue and expenditures on the personal tax return. It is possible for a single member LLC to elect to be an association taxable as a corporation; more specifically, they would elect S corporations status. This would be the preferable form of ownership for an individual.

As mentioned earlier, if an individual elects the ownership form, sole proprietor they may not have the knowledge or ability to secure lending or raise equity to purchase or finance real estate. This is a situation where the partnership form of doing business would be more beneficial. A partnership, or unincorporated organization, consists of two or more partners. The partnership agreement is a negotiated document among the partners who contributed capital and services, which regulates this ownership form. These agreements are not set in stone and can be changed as the partners see fit and agree upon. Some items included in the contract are the name of the partnership and the arrangement type, capital contributions and capital accounts, allocations of profits and losses, operating distributions, distributions upon sale, and management. An important requirement of a partnership is there must be two or more partners. If a partner passes away or withdraws then a legal termination of the partnership may result, unless plans are made to replace the absent partner or the deceased partner's estate is established as a partner.

Another form of ownership is a general partnership which is the association of individual sole proprietors. The problem with this type of partnership is each owner may encounter personal legal liability due to the actions of the other partners. The partners can be jointly and severally liable to claims of creditors and others for business acts performed by the partners. Even worse, each partner is accountable for the acts of the other partners. Due to the risk of this liability exposure, purchasing real estate in this ownership form is not recommended.

Limited liability companies (LLC) are business structures allowed by state law. LLCs are popular because they provide limited personal liability, just like a corporation. All owners have limited personal liability for debts and actions of the LLC. In other ways, LLCs are similar to partnerships, providing management with flexibility and the benefit of pass-through taxation. LLCs have a contract like a partnership agreement; for an LLC it is called an operating agreement. For tax purposes, LLCs are treated as pass-through entities. Each member of an LLC will receive a K-1 to report their pro rata share of the income or loss. This is the most favorable form of ownership for two partners.

Valuing Real Estate for Purchase

When deciding to invest in real estate an investor must know how to value real estate. From a quantitative perspective it is comparable to investing in stocks. An investor must calculate how much profit is to be expected through both renal income and property appreciation. Once the numbers are calculated an investor can make better informed decision when it comes to acquiring and selling properties.

The valuation of real estate is a process which examines the economic value of investing in real estate. There are three methods generally employed by appraisers, which are the comparable sales method, the cost replacement method, and the direct capitalization of net income method. The sales method and the cost replacement method are just as they sound, and these two methods are considered inferior to the direct capitalization of net income method. Following is a discussion of direct capitalization of net income method because this is the method which should be employed by investors when looking to purchase income-producing property.

The direct capitalization of net income method, also known as the cap rate, is a systematic approach which considers two components: the net operating income (NOI) of the property and the capitalization rate. The NOI is the calculation of revenue which the property will generate reduced by operating expenses, but not including taxes and interest payments. In order to determine the expected rental proceeds, an investor can find out what prices the renters are paying, or forecast this figure based on comparable properties nearby. The operating expenses are the expenses incurred day-to-day, such as insurance, maintenance fees, and utility costs.

The future NOI will be discounted by the appropriate discount rate and the proper capitalization rate needs to be used for the type of property to be acquired. The capitalization rate is the required rate of return on real estate, net of appreciation or depreciation. To simplify this equation, it is the rate applied to NOI to determine the present value of a property. The formula for calculating the fair valuation is = NOI/(r-g) = NOI/R where NOI = net operating income, r = required rate of return, g = growth rate of NOI, R = Capitalization rate (r-g). To demonstrate with an example, if an income property is anticipated to create NOI of $30,000 over 5 years, and this was discounted at a capitalization rate of 10%, the fair value of the property would be $300,000 calculated as follows: $30,000/.10= $300,000 (NOI/capitalization rate=market value). The $300,000 valuation would be a great investment if the property can be purchased at $250,000, but it is a poor investment if the property is purchased at $350,000.

Loan Qualification

Purchasing an investment property is comparable to buying a personal residence. To make the acquisition investors will typically need at least a 20% down payment and they can finance the remaining amount. However, qualifying for a loan on an investment property can prove to be tough due to the fact that lenders perceive investment properties as an increased risk. There are some steps an investor can take to improve the chances of getting a loan or even getting a better rate.

First, an individual looking to invest needs to pay down personal debt. If there are outstanding student loans, unpaid medical bills, or credit card debt, it is a good idea to pay these down before trying to purchase an income property. An investor will need a good credit score to obtain an investment loan and paying down outstanding debt will increase the credit score. For credit card debt the debt-to-credit ratio should be 30% or lower. It is also a good idea for an investor to maintain high personal cash reserves. These cash reserves will act as a financial buffer or contingency plan in case the property is not rented, or if the rental income is not sufficient to cover the monthly payments on the property. Lenders like to see high cash reserves, an amount large enough to cover the down payment and about 6 months of monthly payments. This will help convince lenders that the investor is not a high risk.

Qualifying for an investment loan can be challenging. As mentioned, the credit score will need to be fairly high. A high credit rating demonstrates to lenders an investor is money-wise and capable of maintaining an investment property. The debt-to-income ratio needs to be lower. Lenders want to be sure first of all that an investor makes enough money to afford the monthly mortgage payments, but also that there isn't too much personal debt. The down payment of about 20% will mitigate the potential of foreclosure on the property. If a foreclosure takes place the sale of the property may not be enough to cover the total loan, therefore a higher down payment helps to mitigate the risk. Also, if an investor already owns several properties, four or more, it becomes much more difficult to obtain additional investment loans. In this situation an investor needs to get a loan through a special Fannie Mae program. Another requirement when owning several investment properties is that an investor is required to have cash reserves large enough to cover the down payment and 3 months' mortgage payment for the new investment property, and all the investment properties owned. This is a large amount of cash, which needs to be maintained in the bank for 3 months after the loan closes.

Financing

When looking to purchase an income property an investor is could pay cash for the property but more than likely will put some cash down and finance the remainder. As mentioned earlier, investment property loans are considered to be a higher risk loan because investment properties don't always work out. As a result, these types of loans tend to cost more to utilize, typically will have less favorable stipulations, and are more difficult to qualify for. There are a few different financing options for an investor.

An investor could take out a conventional investment property loan. For this loan the lender would require at least a 20% down payment and a credit score around 720, but depending on other items such as credit history and debt-to-income ratio, this rating is flexible. With this type of loan the fees will be an additional .75% and the interest rate will be 1% to 3% higher than a traditional home loan. The loan-to-value (LTV) should be 80% or less and some lenders call for an investor to have 6 months of cash reserves. Also, if an investor has four or more mortgages they will not qualify for a conventional loan. They would be required to utilize the unique program mentioned earlier, which was created by Fannie Mae, and allows investors to have between five and 10 mortgages under their names. To meet the criteria an investor needs to put down a 25% payment on single-family home or 30% for a two-to-four-unit property. An investor with six or more mortgages is also required to have a minimum credit score of 720.

Another option for an investor is a hard money loan. These loans are used more for buying and fixing up properties to turn over in a short time frame. These loans can be beneficial because they are often accepted the same day the application is submitted and the funding is usually accessible within 3 days of the approval. A good credit score is generally not required as long as the investor can put down between 25% and 30% as a down payment. There is no requirement for this loan type to have four or fewer mortgages. The disadvantages to hard money loans are they are for short-term investors so they must be paid back with terms of 1 to 2 years, or 3 to 5 years. Interest rates are usually very high at 9% to 14%, and upfront fees can be as high as 2% to 4% of the loan.

A professional loan is not always required to invest in real estate. An investor can secure funds through private money as well. Some investors know individuals who are looking to invest their extra money, such as family, friends, or property investors. There are advantages to private money. The fees and interest rate tend to be less, the conditions tend to be less strict, and the length of the loan can be negotiated.

Another option to utilize to acquire financing for an investment property is to take out a home equity loan against the equity that is built up in a prime residence. It is much simpler to qualify for a home equity loan and since the primary residence will be used as collateral it should have better terms. Using a home as collateral reduces the risk that an investor will fail to pay on the mortgage. Generally, an investor needs a credit rating of 620 or higher, a debt-to-income ratio of 43% or lower, and a well-established credit history to qualify. A home equity loan is possible for rental real estate because the funds are issued in one lump sum which investors can use as they wish, including on another property. An investor, or anyone for that matter, can borrow up to 80% of their home’s equity value when using a home equity loan.

Financing Timeline

On average the typical lending process for a home loan takes 45 days. The real estate loan process for an investment property works similarly but takes much more time, documentation, and communication. An investment loan is more complex because each lending institution goes by slightly different lending terms and guidelines. This type of loan will take between 45 and 120 days. The time varies depending on the number of documents requested and how quickly each party supplies the requested documents.

The process begins with the loan preapproval and shopping for the right investment property. A preapproval is important so that an investor knows what their price range is; it also makes the approval process go much quicker. Also, when an investor is ready to make an offer on a property the realtor can do so right away because the preapproval process was completed. Otherwise the realtor would have to get the investor approved, and then make the offer. Waiting on the approval can cause an investor to miss out on a good income-producing property.

Once the investor is ready to make an offer the realtor will help to complete a purchase agreement. Some of the items outlined in the purchase agreement are the sales price, down payment amount, closing date, current in-place rents, and so forth. This typically takes 1 to 2 days. The next step is to negotiate an offer. As mentioned, we are currently in a seller's market and most sellers will receive several offers. It can take several days to hear back from the seller's realtor. The seller can accept, reject, or submit a seller's counteroffer. A counteroffer is where negotiations begin. A counteroffer contains a seller's requested changes to the terms of the sale. As a buyer, the investor can even submit a buyer's counteroffer, and this happens quite often. This process will go back and forth as many times as necessary until everyone agrees on the terms and signs the contract. This process can take between 2 to 6 days.

Once the sales agreement is signed the investor will work with the lender who prepares the official loan application and disclosures. The loan disclosures will include a loan estimate. This document lists the closing costs, prepaid insurance and taxes, interest rate, and monthly payment for the loan. After the investor reviews and signs the document the lender sends the loan for approval, or updated approval if the preapproval process was completed. This should take 4 to 6 days.

The next step is the inspection of the property and final negotiations. This can take 4 to 7 days. The home inspection appointment will take a few hours once it is scheduled, but the schedule will depend on the home inspector’s availability. Also, if the home is currently occupied, the schedule will depend on the owner’s availability to allow the inspector inside. Once the inspection is complete the investor will have the opportunity to negotiate repairs with the seller. These negotiations can take a few days to complete. If there are repairs to be done the seller will need to have them scheduled and completed which can take a week or longer.

Once any necessary repairs are completed, the next step is to have the property appraised. Appraisal timelines vary based on the location and the complexity of the assignment, as well as the time of year. For example, an appraisal of a single-family unit will typically be a faster process than that of a three-unit rental home. Appraisals for rental homes and homes with more than one unit require additional time. The appraiser must analyze rental trends in the area in addition to aspects of a standard appraisal report. The appraisal process can take from 1 to 2 weeks.

The next step is final approval and closing disclosures. This can take about 5 to 7 days and includes a mandatory, 3-day cooling off period. At this point the appraisal and any loan conditions will go back through underwriting for a review and final sign off. Once the final approval is back from underwriting, the investor will receive the closing disclosure. The closing disclosure is about the same as the initial disclosure with minimal changes. Again, this is a recap of the final loan terms, closing costs, and prepaid fees, among other things. The mandatory, 3-day cooling off period takes place after receiving the closing disclosure. This cooling off period provides some time to review everything before signing the final closing paperwork. At the conclusion of the 3-day cooling off period, an appointment is set to sign final loan documents. In most cases, signing the final paperwork and funding of the loan do not happen on the same day. Once the loan funds, the documents are recorded at the county recorder’s office and the income property is officially owned by the investor. The closing process can take 2 to 3 days.

CHAPTER V

HOW RESIDENTIAL REAL ESTATE MAKES MONEY FOR INVESTORS

Tax Advantages

There are several tax deductions and tax breaks real estate investors can make use of which can save money at tax time. The tax deductions for rental properties are the costs of owning, operating, and managing a property. Some examples of these costs are property taxes, property insurance, mortgage interest, property management fees, property repairs, capital improvements, ongoing maintenance, and advertising expenses.

As discussed earlier, many real estate investors, in an effort to limit legal liability, decide to purchase and own real estate within an entity, such as a limited liability company (LLC) or limited partnership (LP). Operating in these types of entities opens the door for a variety of additional tax deductions through the operation of the investment business. Some of the additional expenses are supplies such as business cards; legal and professional fees such as an accountant; business equipment such as an office desk or phone; a home office or an office space; communication equipment such as the internet or phone line used for business purposes; travel expenses including vehicle mileage and bridge tolls; education and membership dues; and meals, providing the meal is with potential or current clients or a partner and business matters are discussed. Meals can only be deducted at 50% of the meal expense and a home office can be deducted at $5 per sq. ft. with a maximum of 300 sq. ft. Capital improvements are listed on an asset schedule and depreciated over the life of the asset. Other additional expenses listed can be deducted at face value.

Investors may also deduct depreciation on their properties. Depreciation is an accounting term for the loss in value from average use and wear and tear. Depreciation is deducted over the useful life of the property. For residential property the useful life is 27.5 years, and 39 years for a commercial property. For example, if a single-family rental is purchased for $250,000, the deduction for annual depreciation is $9,091 each year ($250,000/27.5 years). Certain capital improvements for repairing and replacing broken items are also depreciated over a period of years. For example, replacing a roof or installing a new whole house fan can be depreciated. This additional deduction provides even greater savings on annual taxes. As a note, only the cost of the structure is depreciated, never the land.

Homeowners cannot deduct depreciation on personal residences. This deduction is only allowed on investment properties, which makes this a significant tax advantage available only to real estate investors. However, as mentioned, depreciation is only available for 27.5 or 39 years, and a downside to depreciation is when the property is sold, the investor must recapture the depreciation. This means the amount which was originally deducted as depreciation throughout the years is then added back to income and taxed as ordinary income with a maximum tax rate of 25%. To avoid depreciation recapture an investor can utilize a section 1031 exchange which will be discussed later in this chapter.

Another tax advantage of real estate property is the ability to produce a cash flow which is earned without even continually working for it. This is known as passive income, which is not to be confused with a passive activity. The Internal Revenue Service (IRS) describes passive income as any monies that are earned from rental or business activity and the investor does not materially participate. The IRS clearly excludes residual income from passive investments such as interest from mortgage notes or dividends. By that definition passive income in real estate is generally earned from rental income. In the past the only way to offset passive income was with passive losses. But when the Tax Cuts and Jobs Act was passed by President Trump in 2008, businesses that earn qualified business income (QBI) including rental income, are able exploit a pass-through deduction to pass up to 20% of taxable income. There is a restriction on which types of incomes qualify and investors can only take advantage of this deduction if their business is profitable.

A very favorable tax advantage is when an investor sells a property for an appreciated value greater than the original purchase price, and that increase is taxed as a short-term or long-term capital gain depending on the length of time the property was held for. This is advantageous because capital gains taxes are typically taxed at lower rates than ordinary income tax. Short-term capital gains tax is imposed on properties held 1 year or less, and can range from 10% to 37% depending on the investor’s tax bracket. Long-term capital gains realized from properties held a year or longer are taxed more favorably, from 0% to 20% depending on the income bracket.

As mentioned, there is a way to avoid paying the capital gains tax for a property which is sold for a gain. An investor can utilize a 1031 exchange. This tax treatment received its name from Section 1031 of the IRS tax code. Essentially, this tax law allows an investor to exchange one investment property for another, like-kind property. This would create the avoidance of capital gains and depreciation recapture on the sale of the property. In order to complete a 1031 exchange an investor needs to own the property for a minimum of 2 years, and must identify a replacement property for the assets sold within 45 days and then conclude the exchange within 180 days.

To demonstrate how these benefits can add up, here is an example of a simple real estate transaction which incorporates some of the real estate tax advantages which were just discussed. Assume a rental property for $200,000 is purchased, with a 20% or $40,000 down payment. Again, assume the annual rental income is $16,000 and $13,000 in expenses was incurred, leaving a net income of $3,000. The investor can take advantage of the depreciation deduction in order to deduct an additional $7,273 in depreciation expense, turning that net income into a net loss of close to ($4,300). This example demonstrates how an investor earned $3,000 in passive income and paid no income tax due to the noncash depreciation transaction.

Continuing with the example, if an investor has additional passive income from other rentals which do not result in a net loss, they can use this passive loss to offset that income. The benefits from tax deductions and tax laws keep going. If the property in this example is one of many an investor owns and all properties are held in an LLC, they could utilize the pass-through deduction, thereby reducing their net income by an extra 20%. For example, assuming the other investments are earning around $20,000 a year in qualified business income, this income will be reduced by $4,000 for tax purposes.

Going even further with the example, now assume the investor decides to sell the property 10 years later for $300,000 using a 1031 exchange. The 1031 exchange will aid in avoiding the recapture of $72,727 in depreciation, and the investor will avoid $50,000 of capital gains from the appreciation of the old property and will roll it into the new investment property, which hopefully will produce more income than the sold property. This example illustrates how over the 10 years of ownership, an investor may pay little or no tax. This is a very simple example of how the tax advantages can benefit real estate investors. Everyone is required to pay taxes, but the amount an investor pays is limited by taking advantage of various real estate tax laws.

Income Today and Tomorrow

Income Today

Real estate generates wealth in a few ways. One way is by providing regular payments of income, referred to as rent. The tenant pays a fixed amount every month, which will increase or decrease depending on market demand and the supply of similar units. The costs of upkeep of the property reduce the income amount, and the remaining portion is claimed as rental income. A rental in a great location is vital to ensuring the investor will not have any trouble luring renters. The location will determine the amount of rent to charge. Determining what is the proper amount to charge in rent can prove to be challenging because too high a price will lead to difficulty in obtaining tenants, and too low a price will leave cash on the table. Ideally investors should price the rent at an amount which will cover the various expenses of owning and operating the property.

Income Tomorrow

When owning rental property investors also earn a profit through appreciation. Appreciation is the increase in value from when the asset was purchased to the time it is sold. Appreciation is achieved through various ways such as, a good location, improvements made to the property, and development of the area where the property is located. These are the main ways that real estate will appreciate in value, but inflation will also increase property values over time. Once again, the only way this income is realized is when the property is sold. With this increase in appreciation, an investor may also choose to borrow against the equity and make another investment in a different piece of property. It is also important to note that while real estate tends to appreciate, there are no guarantees. The lack of appreciation was evident during periods like the late 1980s and early 1990s, and also the years 2007 to 2009 when the real estate market collapsed.

Investors should be aware that location plays the biggest role in appreciation. When neighborhoods in the area of the rental develop, adding public transportation routes, schools, shopping centers, playgrounds, and more, home values will increase. Naturally, if the area where the rental is located decline the property value will decrease. Improvements to the building and property can also cause an increase in appreciation. For example, adding an extra room or remodeling the bathrooms are ways to increase the value of a rental property.

An investor can also increase the return on investment of a property. If they borrowed to purchase the property an investor may choose to refinance the loan at a lower interest rate when the rate declines. This will lower the cost basis for the property, resulting in more net income.

Compared to Other Investments

Many investors turn to the stock market when they have extra funds to invest because many do not realize investing in real estate is a great investment option. Under the right circumstances, real estate offers an alternative that faces lower risk, yields better returns, and offers greater diversification. Which investment option to choose is a personal choice that depends on the amount an investor has available to spend, risk tolerance, goals, and investment style. Investing in the stock market doesn't necessarily take much time or money. But when buying real estate, an investor has to save and put down a substantial amount of money, and devote a considerable amount of time.

Real estate and stocks face different types of risks and opportunities. The stock market is subject to market risk, economic risks, and inflationary risk, thus it is extremely volatile. Typically, the real estate market undergoes lower volatility, especially compared with equities and bonds. Real estate investing allows an investor to experience a better diversification potential. The author has learned the importance of diversifying a portfolio in undergraduate and graduate finance classes. As discussed in Chapter I, real estate has a low, in some cases negative correlation with other asset types, which means, when stock values decline, real estate values increase. Hence, adding investment properties to an investment portfolio can lower its volatility.

There will often be less principal-agent conflict involving direct real estate, and the reliance on the integrity and competence of managers and debtors is minimized. There can be some principal-agent conflict in the purchase process of real estate, but ultimately if the realtor wants to make a sale they will work to minimize this conflict. The same can be said for a property management company managing an investor's property, if that is the route the investor chooses. The property management company ultimately works for the investor, and if they are not performing the job adequately the investor has the choice to hire a new company.

Another reason to invest in real estate is the ability to hedge against inflation. The inflation-hedging capability of real estate stems from the positive relationship between gross domestic product (GDP) growth and the demand for real estate. Rabson Magweva and Mabutho Sibanda explain, "GDP was found to be positive and significant in determining real estate returns using dynamic fixed effects in the long run, which is acceptable given the nondefensive long-term nature of real estate assets" (Magweva & Sibanda, 2020). As economies expand, the demand for real estate drives rents higher, which translates into higher capital values. Therefore, real estate tends to maintain the purchasing power of capital, bypassing some of the inflationary pressure on to tenants, in the form of rent, and incorporating some of the inflationary pressure, in the form of capital appreciation.

One tool real estate investors' benefit from which is not available in the stock market is the power of leverage. When stock is purchased the full value of the stock is paid for at that time. Conventional mortgages are structured with a 20% down payment but this can vary. With government programs and depending on where an investor lives, they may be able to finance a mortgage with as little as 5% down. This means the purchaser can control 100% of the property and the equity it holds by only paying a small percentage of the total value. Keep in mind, the size of the mortgage will directly affect the amount of ownership an investor actually has in the property, but once the papers are signed they control it. This type of instant control with very little down relative to the whole property value is what encourages investments in real estate. An option for someone looking to invest in a rental property is to take out a second mortgage on their principal residence in order to put down payments on two or three other properties. Then they can rent out the properties so the tenants pay the mortgage, or they can wait for an opportunity to sell them for a profit. In either case, despite paying only a slight portion of the total property value they control the assets.

Real estate can be a strong investment with the possibility to offer steady cash flow and build wealth. With anything good there is always a downside. One disadvantage of investing in real estate is illiquidity. Difficulty can occur in converting real estate into cash. Stock or bond transactions can be completed in a matter of seconds, but a real estate transaction can take months to finalize. Brokers assist to move these transactions along, but even with help, finding the right counterpart can take a few weeks of work. As with any investment, investors should have realistic expectations and conduct research before making any decisions.

Rate of Return for Rental Properties Versus Stock and Bond Portfolios

To some extent, the return on investment (ROI) depends on the investor's tolerance for risk. The more risk an investor is willing to take, the higher the ROI to be expected. On the other hand, risk-averse investors will more than likely want to settle for a lower ROI in an effort to keep more certainty. As a rule of thumb, the real estate investor's goal is for returns to match or exceed the average returns on the S&P 500. According to CNBC's senior market commentator, Michael Santoli, the historical average S&P 500 return is around 10% (Santoli, 2017).

A team of economists from the University of California, Davis, the University of Bonn, and the German central bank conducted a study to determine which investments had greater ROI. Brian Davis explains, "In a nutshell, they found that residential rental properties boasted long-term returns of over 7%, while equities' long-term returns fell under 7%. Bonds and bills lagged far behind both" (Davis, 2020). They compared returns on several asset classes, including equities, residential real estate, short-term treasury bills, and longer-term treasury bonds. In order to level the playing field they adjusted for inflation and included all types of returns. Dividend income was included for equities, and rental income was included for residential real estate. Average annual return by investment is shown in Figure 9.

Figure 9. Average annual return on investments. (Davis, 2020)

The economists also took risk into consideration when evaluating different types of investments. Treasury bills are the least risky, followed by real estate, bonds, and stocks. To measure risk against return for an investment they used an index called the Sharpe ratio, named after its inventor, William Sharpe. A higher ratio implies greater return relative to a given risk level, which indicates a better investment. T-bonds came in with a low Sharpe ratio of .2, stock investments came in at .27, but residential real estate came in at .7.

CHAPTER VI

RISK OF RENTAL PROPERTY

According to Gallup's annual Economy and Personal Finance survey conducted in early April 2020, since 2013, real estate has been the top investment pick for the majority of Americans, at 35%. Sully Barrett states, “Thirty-five percent of Americans say real estate is the most favored long-term investment, which has been the case since 2013. Over one third of Americans have named real estate as the top investment since 2016” (Barrett, 2020). Real estate is preferred over stocks and mutual funds (21%), savings accounts (17%), gold (16%), and bonds (18%). While real estate may be the most popular investment pick, still it faces certain risks.

Economic Risk

As with the stock market, the real estate market can be unpredictable. Many people wrongfully had one thought, which was the real estate market was going to continue moving in one direction and that was up. This was of course until the 2008 Great Recession. The basic assumption by many was to buy a property, and in the future they would be able to sell it for more. While it is true that real estate values tend to increase through the years, the real estate market can be unpredictable and investments can depreciate. Several economic factors entail risk for an investor. Supply and demand, the economy, demographics, interest rates, government policies, and unforeseen events all play a role in real estate trends in terms of price and rental rates. Currently the real estate market is dealing with the outcomes of COVID-19 and the effects are still to be determined. In order to decrease the risk of being caught in one of the real estate trends or cycles, an investor must conduct careful research, perform their due diligence, and constantly monitor their real estate holdings.

Location plays a large role in the risk taken by an investor. Location ultimately drives the factors that determine the profit an investor can make. The demand for rental properties and the types of properties that are in demand, the tenant pool, rent prices, and the potential for appreciation are all affected by location. It is very important for an investor to conduct research to find a good location to invest in.

Investors have to think about the risk of negative cash flows. Cash flow is the money left over after paying all expenses. A negative cash flow is generated when there is not enough money to cover all the expenses. Reasons for negative cash flow are high vacancy, too much maintenance, high financing costs, low rent, and not using an appropriate rent strategy. An example of a rent strategy is choosing to focus on long-term tenants or Airbnb. Once again, the best way to reduce risk is to do the proper research and prepare cash flow calculations. When preparing the calculations, it is a good idea to establish a contingency fund in case of unplanned events.

As mentioned, one of the reasons for negative cash flows can be high vacancy rates, which is another risk that investors need to pay attention to. High vacancy rates cause an investor to not collect enough rent to cover the expenses, ultimately creating a negative cash flow. High vacancies can be very troublesome if an investor counts on a renter to pay for the property's mortgage, insurance, property taxes, maintenance, and other expenses. In order to avoid the potential risk of high vacancy an investor needs to buy an investment property that is highly sought after and in a good location. Investors can also be sure to set rental rates according to the market rate of the area and begin searching for a replacement tenant as soon as the current one gives notice.

Damage

In order for investors to avoid vacancy risk, they should keep their rentals occupied at all times, but high occupancy can cause a second risk which is problem tenants. A problem tenant sometimes can cause more of a financial drain than if the rental was vacant. Some common problems with tenants include not paying on time or not paying at all. This can lead to a drawn out and expensive eviction process. Tenants can damage the property or not report maintenance issues until it is too late. Repairs that need to be addressed in a timely manner but are not addressed can exacerbate the damage and lead to higher costs later. Tenants might host extra roommates or have pets which can cause damage and lead to more expenses. With an investment property there is no way to entirely avoid problem tenants, but investors can protect themselves by conducting an extensive background and credit checks. It is also a good idea to contact each potential tenant's previous landlords identified in the application to search for potential problem indicators such as late payments, property damage, and evictions. Of course, investors can also protect themselves and their properties by having adequate insurance against losses and liabilities.

Investors can also experience hidden risks such as structural problems or termites and termite damage. One sure way for an investor to go belly up on an investment is to miscalculate the cost for repairs and maintenance. For example, an investor could be looking at as much as $15,000 to repair the roof of a typical single-family home. A thorough inspection of the property made during the purchase process can help to lower this risk. It is important to hire a reputable and qualified inspector to conduct the property inspection. When problems are identified, an investor should find out how much it will cost to fix. The investor either works that cost into the deal or walks away if it would affect the future profitability of the property.

CHAPTER VII

HOW TO MANAGE RENTAL PROPERTIES

Once an individual invests in a rental property, she becomes a landlord. At this point an investor needs to consider the pros and cons of being a landlord. She needs to consider if she will be comfortable in that role. As a landlord, she will be responsible for a variety of tasks such as paying the mortgage, property taxes, and insurance; maintaining the property, finding tenants, and dealing with any problems. Being a landlord requires a lot of involvement with the property. She may consider hiring a property management company to take care of the details. Depending on the situation, taking care of the property and the tenants can be a full-time job, and a job that is not always pleasant. Careful consideration must be given to what is the best option for the investor and this can depend on various factors.

Self-Manage

An investor with DIY and renovation skills would be ideal to self-manage. To self-manage properties an investor should have the patience and time to manage tenants. If an investor has the time, and is just starting out, then it is likely she will want to save the hefty fee that often comes along with property management companies. If the decision is made to self-manage then the investor had better be prepared to put in the time, because it will not be easy. The job of self-managing properties requires huge commitment from the owner because managing requires constant management tasks, such as chasing late payments, ensuring the welfare of the tenants, performing inspections from time-to-time, and many other time-consuming tasks.

Of course, the number one benefit of self-managing rental properties is to save on property management fees. Owners pay property managers a fee or a percentage of the rent generated by a property while under management. To save on repair expenses an investor can handle repairs on their own. If the investor hires a property management company then all repairs are outsourced to maintenance companies, and this may cost significantly more than if the landlord had handled the repair.

When self-managing the landlord will know the property is being taken care of in the best possible manner. An owner tends to manage the property better than a property management company. There's the old saying, "If you want something done right, you have to do it yourself." When investors are managing the property and have DIY skills they can fix issues on their own and make sure it is done right. If the repair is something the landlord cannot fix, they can seek the maintenance company of their choice. They can also follow up to make sure the repair was done properly.

When owners manage their own property they will have a larger tenant selection than a management company because those companies are trying to fill multiple rentals. They can personally evaluate the application forms and speak with the potential renters themselves. An owner can determine if a tenant would be a good fit for the property and conduct the necessary background checks. Since the property is owned by the landlord, they can go to extra lengths to ensure their rental has a tenant at all times. If the help of property managers is used, they have multiple properties to manage, which means the landlord’s property may not get all the attention the landlord would like. When management companies are responsible for numerous properties there is the chance that a manager will not manage a rental property as well as an investor would like, regardless of how professional they are.

Property Management Company

Property owners who have one or two homes often do their own repairs to save money. They could hire a property management company to do it all for them, but that will eat into their profits. Of course, as investors add more properties to their portfolio self-managing becomes more difficult. Some investors lack the time or expertise to maintain the properties and deal with tenants, and they resort to management companies, but this will be an added cost on the list of expenses. To some investors the extra costs may be worth it. One of the biggest benefits of having a management company is they minimize stress by doing all the work so the owner does not have to. Most property managers will have a good understanding of the market and are well aware of the intricate details of property management.

When dealing with rental properties and tenants there will be some critical situations, and at times an owner’s emotions may get in the way. This is when having property managers would be beneficial to handle deviant tenants, as well as any possible damage to the property. Another area where it is beneficial to rely on property management is with legal and ethical situations. Rental property owners may not be informed of up-to-date, vital information that a property manager may have. Lacking vital information cripples an investor’s capability to make informed decisions, which may not only negatively their revenue, but also result in legal implications. Another benefit of hiring a property manager is that they have access to a wealth of real estate resources which can be essential to certain tasks such as marketing that the property is available to rent. If an investor does not have access to great resources and connections it could ultimately impact their rental returns.

If an owner does not live near a property or has plans to move, hiring a property manager eliminates the need for the owner to be nearby in order to actively manage the property. If the owner lives in a different city or state of course they will not be able to oversee the property very easily. Hiring a management company allows a real estate investor to focus on investing in more quality properties in other areas, not just those in their vicinity. Rather than spending all their time managing the portfolio of properties currently owned, they have time to look for opportunities to invest in other potentially beneficial communities.

When entrusting a rental to a property manager there is a potential for deceit and theft. If an investor does not research and find a reputable management company, they could end up in the hands of an incompetent property manager. Even worse, they could end up with one who is not honest. Some potential problems an owner could encounter with an untrustworthy manager are overcharging for maintenance, collecting for maintenance which never took place, and even collecting extra money from tenants to fill their own pockets and never remitting to the owner.

CHAPTER VIII

SALE OF RENTAL PROPERTY

When is the Best Time to Sell?

Being a real estate investor and investing in rental properties is all about maximizing profits. However, there can be a risk when holding onto a rental property for too long and there is the possibility of loss. It can be very difficult to know when the right time to sell a rental property is. Trying to predict the precise movements of the real estate market is not realistic, but there are situations which signal when it could be a good time to sell a property.

Situations can arise when it makes more sense to sell a piece of property than it does to hold onto it. If the hassle is more than what an owner is willing to take on it may be time to sell the property. For example, emergency calls by tenants don't just happen during normal working hours, they happen even during the night. If the property is self-managed the investor will need to be ready to answer calls at all hours. On the other hand, if the property is managed by a company, numerous service calls can eat into profits. If constant repair calls are causing the cash flow to be negative the owner should consider selling the property. Landlord aggravations are not limited to tenants calling at all hours with maintenance issues. An owner also has to think about fluctuating values, as well as the possibility of natural disasters such as earthquakes and floods. If the revenue does not equal the stress then it may be time to sell the property.

As discussed, one of the ways investors make money on real estate is through appreciation. If the property is worth more than an investor paid for it, selling could earn more revenue than renting. For example, if a property was purchased in a growing and thriving neighborhood the value would more than likely increase. When a property has appreciated an investor can make a significant profit on that increase. How much increase in appreciation is enough to sell varies by investor. When deciding how much appreciation is enough, investors need to consider several factors, such as the monthly cash flow from rents, capital gains tax they will pay, feasibility of utilizing a section 1031 exchange, and so forth.

An obvious sign to sell a rental property is when there is no longer a positive cash flow. If the investor is losing money each month she might need to reevaluate the situation. There are many reasons the cash flow could be dwindling, and it is not necessarily anyone's fault. The cost of taxes, utilities, and insurance may have risen, market rents may have dropped, or a combination of both. People purchase investment properties to generate a profit so when there is no longer a profit it is time to sell. Some investors may have a hard time coming to terms with a property not generating positive cash flow. They may feel they can turn it around to make a profit when conditions change, but how long will that take? In this situation an investor can ask themselves the question, "Would I buy this investment today?" If the answer is no, then again, it is time to unload it.

The depreciation which can be deducted for tax purposes can run out. Depreciation expense is a noncash item that is all about saving when it comes to tax time. This deduction has an expiration date. For single family homes it is 27.5 years and for multifamily units it is 39 years. When this deduction reaches the end of its life an investor may no longer be able to make a profit, and it may be a good time to sell.

There are many reasons driving an investor to sell a property rather than hanging onto it. Investors need to be able to read the writing on the wall to make the best decision. Every situation is different so the question of when is the best time to sell becomes a personal preference. Kenny Rogers explained it the best in his song The Gambler, “You’ve got to know when to hold ‘em, know when to fold ‘em, know when to walk away, and know when to run.”

How to Calculate a Gain or Loss on the Disposition of Property

There comes a time in every investor’s journey when they need to sell a rental property, so it is important they know how to calculate the gain or loss on the sale. The process involves a few steps, but the calculations are simple. The first step is to determine all the selling costs. Selling costs include, but are not limited to, real estate agent fees, repairs, closing costs, and home warranty fees. The next step is to calculate the adjusted cost basis. A formula for determining the adjusted cost basis is,

adjusted cost basis = purchase price – depreciation + improvements

The closing costs paid on the purchase, sales tax, other taxes, and any associated fees are added to the purchase price.

With all the variables determined the gain or loss can be calculated. A gain or loss realized equals the difference between the amount realized, net of any selling expenses, and the adjusted basis of the property at the date of disposition. As mentioned, the net amount realized from a sale is the gross selling price reduced by the transferor's selling costs, such as transfer taxes, and real estate professional's commission. If a property with an adjusted base of $200,000 is sold for $300,000, with selling expenses of $10,000, the amount realized is as follows:

Sale Price	$300,000
Less: Selling expenses	(10,000)
Less: Adjusted basis	(200,000)
Gain on sale	$90,000

Of this $90,000 gain, if depreciation of $50,000 was deducted, this amount would be taxed for the depreciation recapture. Depreciation recapture is usually taxed at 25%. The remaining $40,000 gain would be subject to a capital gains tax rate ranging from 0% to 15%, depending on the seller's taxable income. Keep in mind, if an investor purchases a like-kind property and takes advantage of section 1031, she can avoid depreciation recapture.

CHAPTER IX

CONCLUSION

The Future of Residential Real Estate

What is the future of real estate going to look like? It has become apparent that the current pandemic will lead to many changes in human behavior and result in certain socioeconomic trends. But what effect will it have on real estate? Is the housing market going to continue to recover or will it crash? As mentioned, currently the market is continuing to rise, however, at a much slower rate compared with the past 6 years. It is difficult to predict where the market will go from here. Some experts believe the housing market will continue the upward motion in the second half of 2020 and into 2021. Other experts believe the housing market will slow due to the pandemic. Social distancing and wearing a mask in response to the coronavirus have created difficulty in showing homes, communicating, and completing documents. Many people are just sitting tight waiting for this difficult situation to pass.

Dima Williams claims, “Mortgage rates are searching for a historic bottom. Home prices are inching up toward record highs. Home shoppers are looking for deals. Homeowners are weighing selling versus refinancing” (Williams, 2020). Let us look at what we know right now about the current real estate market. As discussed, housing prices continue to slowly increase due to tight supply. This has caused sellers to regain leverage. Demand is also increasing. Increased demand with low supply creates a seller's market. The scenario is represented in the basic economic theory of the law of supply and demand. Mortgage rates are extremely low which also drives demand up.

With demand increasing home sales are also increasing. The sales market is recovering from the setback of the shutdown of California due to the pandemic. The second half of 2020 is expected to see an increase in sales. The supply probably will not see an increase. This figure is expected to remain flat or increase slightly. Entering the fourth quarter, when peak sales months are ending, fewer homes are listed for sale.

Increasing demand translates to increasing sales, so home prices are rising, which is causing rental rates to increase as well. Think of it like a domino effect. This is making things even harder for families who don't already have their foot in the door in the real estate market. Affordability was already a problem in the housing market before the coronavirus pandemic hit. The sales price of homes continues to increase making homes difficult to afford. One factor counterbalancing these increased prices is historically low mortgage rates. Lower rates reduce monthly payments by reducing the amount of interest paid, making homes a little more affordable.

For the remainder of 2020 and into 2021, the housing market probably will not see much movement. Marco Santarelli of Norada Real Estate Investments explains home prices are forecasted to increase 1.1% which is near flat. He also believes inventory will remain low, and mortgage rates should remain low. Santarelli thinks mortgage rates could slide to below 3% by the end of 2021. While these most recent predictions of a real estate market with no movement seem bleak, many experts were originally predicting a housing crash worse than the Great Depression. Compared to the first predictions of the housing market amid COVID-19, a stagnant market is preferable over a housing market crash.

Modesto and the surrounding communities are worthwhile areas to invest in. As discussed, this area is continuing to grow and experience development. The Modesto area is experiencing population growth at 0.86% annually. Housing prices in the Modesto areas have not appreciated as quickly as the national housing market. Increases in home values are still expected to occur, which means it is not too late for investors to invest in those areas and realize the benefits of appreciation. Along with the increase in appreciation that is expected to be realized, rent prices have been steadily on the rise. Investors have the potential to see higher returns on their investment from appreciation and rent.

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