FINANCIAL ADVISORY

Assets vs. Equity

How Can Understanding the Difference Help Me Grow Wealth?

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My idea from this month's article came from a recent philosophical conversation with a client. We were discussing the difference between Assets and Equity. Understanding the difference between the two can help real estate investors immensely.

WHAT IS THE DIFFERENCE BETWEEN TOTAL EQUITY AND TOTAL ASSETS?

I think the best way to explain the difference is to consider your own personal financial statement. In a financial statement, you list everything you own on the left side and list all of your debts (liabilities) on the left. Your assets are the sum of everything in the left column. Your equity is assets – liabilities: the sum of everything in the right column.

Your Financial Statement probably includes some liabilities that are not investment related: auto loans or student loans for yourself, your children or grandchildren, for example. To evaluate these categories from an investment standpoint, we need to individually review our investments and look at the assets vs. equity in each.

DEFINITIONS OF EQUITY AND ASSETS

If you own a 4-unit property worth $1,500,000 and your loan on the property is $1,000,000, then your Equity represents the value of your asset less the loan amount: basically the amount, (ignoring transaction costs), of money you could get your hands on if you sold the property.

Your Assets in the above example would be $1,500,000. After all, you own that property and nobody else does – even if the bank fronted most of the purchase price. What good is a larger Assets number if I can't get my hands on that cash right away? Let's discuss how using leverage to turn your equity into more assets can help you.

HOW LEVERAGE CAN HELP YOU – APPRECIATION POTENTIAL

Leverage can help investors by allowing them to multiply their equity to acquire more assets. A great feature of leverage is that a bank will lend us most of the money to buy a property, but we get to keep all of the profits. This will be easiest to understand for real estate investors. If I bought a house here in California in 1986 for $200,000 and sold it this year for $1,200,000, that will represent a 600% return on my initial investment. If – on the other hand – I purchased that house with a 20% down payment of $40,000 and financed the rest, I have turned $40,000 into $1.2 million over 35 years for a 3,000% return on equity.

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over four hundred 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

What can that higher return on leveraged equity do for me? If I had $200,000 in my checking account at that time, I could have bought that house all-cash, and would have $1.2 million today. If, however, I bought 5 houses with separate $40,000 down payments, I would have $6 million today – all from the power of leverage.

HOW LEVERAGE CAN HELP YOU – HIGHER INCOME POTENTIAL

A second excellent benefit of using debt financing is the potential for positive leverage. If I buy some apartments at a 5% CAP, that estimates my income – if I buy it ALL-CASH - at 5%. If I can buy that property with 50% leverage and a 4% interest rate, that means I'm earning 5% on the portion that the bank "bought" and that I only need to pay them 4%. I am earning a 1% "spread" on the bank's money, so this can make my income look something like 5.5%.

HOW LEVERAGE CAN HELP YOU – MORE DEPRECIATION POTENTIAL

My investors are buying new property through 1031 Exchanges. In doing so, they will avoid paying their capital gains and accumulated depreciation taxes by "carrying forward" their tax basis to a new property. This means that they keep their old depreciation schedule – unless they use leverage.

Perhaps you own a, (for example), property worth $1 million. During your long ownership of this property, you have exhausted all your depreciation benefits. By using a moderate amount of leverage, such as 50%, to buy your replacement property, we could then buy you a $2 million asset. The IRS will call this $1 million of additional property "new basis" that you can start depreciating immediately over 27 ½ years. (For residential properties.) This will defer (perhaps forever) income taxes on $36,363 of income every year. ($1,000,000/27.5 = $36,363).

HOW LEVERAGE CAN HURT YOU

The presence of leverage, of course, brings foreclosure risk as well. When you borrow money, you will need to send the bank their payments. If your income on the property goes down, that could jeopardize your ability to make those payments. If you miss enough of those payments, the bank will take the property from you.

I think that, through the use of moderate leverage and careful evaluation of prospective purchases, we can manage this foreclosure risk. I also realize that it is certainly possible to suffer catastrophic losses with unleveraged properties as well. With this in mind, I think the added risk of leverage can certainly be worth the potential rewards.

Are you using your equity to buy assets for future growth? If you'd like to discuss, my office number is (877) 313-1868.

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I have completed over four hundred 1031 exchanges for investors.
$200,000+ equity required.

Learn more about our investment programs at www.ChrisMiller1031.com

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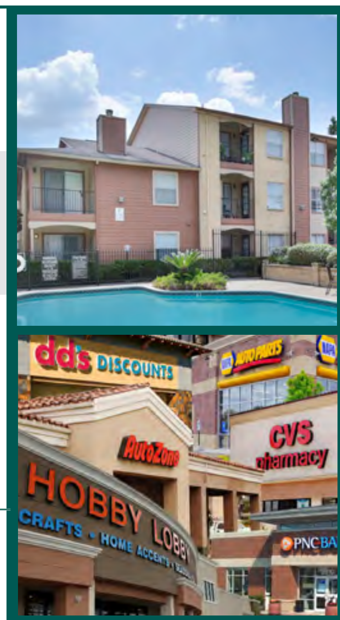

Investing in real estate, with or without use of a 1031 exchange, carries the risk of losing your principal, income or tax benefits. Additionally, the IRS has issued inflexible guidelines for completing tax-deferred 1031 exchanges. Failure to follow these guidelines could lead to a loss of tax benefits. 1031 Exchanges can involve significant fees. This does not constitute an offer to buy or sell any security. Investments may be illiquid in nature and those seeking to dispose of their investments early may be unable to do so. Securities offered through Emerson Equity LLC. Member FINRA/SIPC, MSRB registered. Advisory services offered through Emerson Equity LLC an SEC registered investment advisory. Emerson Equity LLC and Specialized Wealth Management are unaffiliated.