FINANCIAL ADVISORY

Real Estate Principles: Introduction to the Time Value of Money

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This month, I'll be continuing my "Investment Real Estate Principles" series by discussing an important financial theory: The Time Value of Money. This model states that $100,000 in hand today is much more valuable than $100,000 on this day next year due to that money's present earning power. If I invested that $100,000 today, I could earn income for the next 12 months, and my $100,000 could appreciate as well. Next year, I could have my $100,000 principal + $5,000 of income +$3,000 of appreciation, or I could just be starting with $100,000.

An important part of this discussion is the concept of Opportunity Cost. In the above example, my opportunity cost of waiting 1 year to collect my $100,000 is the potential to earn $8,000 during that time. Let's use the Time Value of Money concept to help us analyze some investment decisions:

SHOULD I PAY THE TAX AND BUY STOCKS, OR STAY IN REAL ESTATE THROUGH A 1031 EXCHANGE

Sometimes investors will tell me "my stockbroker says I should just pay the tax and he'll make it back for me." "Of course he does," I say. That is a bit like walking into a Cadillac dealer and asking the salesman if you should buy a BMW. What's he going to say? We can cut through opinions on all sides by looking at the facts: what does the Time Value of Money tell me?

Let's say that our investor bought 4 units in 1999 for $295,000 and sold it this year for $1,320,000. That is a $1,025,000 Capital Gain that will be taxed at 20% Federal, 9.3% California. ($205,000+$95,325=$300,325) Next, you'll need to pay tax on the $180,218 of depreciation that you've taken over the last 21 years at 25% Federal, 9.3% California. ($45,055+$16,760=$61,815)

Please turn to page CS-36

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Continued from page CS-34

Lastly, don't forget about the 3.8% "Obamacare" tax on the gains – this adds another $38,900 and makes your total tax bill ($300,325+$61,815+$38,900=$401,040. That is a lot to "make back."

After you take your $1,320,000 of sales proceeds and repay the $137,855 on the loan, you have $1,182,145. Take away those $401,040 of taxes, and you're left with $781,105 of sales proceeds. Would you rather start with $781,105 today or $1,182,145? If you pick that lower number, you will need to earn 51% just to get back to even! Remember, too, that while your stocks are working hard to "get back to even," your real estate is earning you income and growth potential. The Time Value of Money principle shows that there is considerable opportunity cost in choosing to pay taxes and buy stocks.

SHOULD I BUY REAL ESTATE FOR INCOME OR FOR APPRECIATION POTENTIAL?

Us real estate investors, of course, are buying our properties for the potential to earn both. Although one property will appreciate at its own rate, we can affect the rate at which the equity invested in it appreciates. For this example, let's choose a 4-unit apartment property here in Southern California that is priced at $1,350,000 and produces a Net Operating Income (NOI – Income After expenses but Before loan payments) of $52,090. You will notice that is a 3.86 % CAP Rate – and that is why a lot of my clients are looking to exchange out of California.

I was going to walk through the calculations behind our evaluation but realized that this paragraph may then end up reading like a math textbook. I will, instead, just "cut to the chase" and conservatively assume a sales price of $1,750,000 in 2030, and that we will be able to grow rents annually until then.

If we fund our acquisition with a focus on income, we will want to make a larger down payment $1 million with a smaller, $350,000 loan. Such an arrangement will yield us a cash-on-cash return of $32,038 annually. In 2030, we'll find that our $1,000,000 investment has turned into $1,460,000 (after the loan was paid back) plus $580,000 of cash flow along the way for an Internal Rate of Return (IRR) of 8.14%.

Choosing an acquisition strategy focused on appreciation will involve making the minimum down payment that our lender will accept – let's call it 20% or $270,000. We will then fund the balance with a $1,080,000 loan. Such an arrangement will result – due to the higher mortgage payment – in a negative cash on cash return to start of about -$815 per month. However, upon sale we will see that we turned our $270,000 investment into $900,000 of sales proceeds and earned $119,000 of income over the holding period. (That's our net after the first three years of negative income). This is an Internal Rate of Return of 16.3%

By using the Time Value of Money, my financial calculator tells us that the second investment has performed better – it has produced less returns, but with a much lower initial cash outlay. An investor could use that $1,000,000 or equity to buy four such 4-unit buildings to potentially have $3,600,000 of principal in 10 years.

Which route is best for you? This depends on your individual situation. The right choice for you will become clearer when we look at the opportunity cost presented by each option.

When I buy with a higher down payment, my mortgage payment is less every month. This leaves more spendable income for me today and in the future. My opportunity cost is missed appreciation potential: As my loan amortizes, it accelerates my appreciation. The less loan I use; the less I can benefit from this acceleration.

An investor purchasing with higher leverage is seeking maximum appreciation of his equity. One great benefit of debt financing is that I can find a bank to put up most of the money for a property. Provided that my mortgage payments are made on time, I get to keep ALL the appreciation that my building enjoys. My opportunity cost, however, is that I am giving up current income.

Investors will view these opportunity costs in different ways depending on their individual situations. I, for example, have kids that will be starting college in 10 years – so that appreciation is attractive to me. In contrast, I have clients who are

Please turn to page CS-39

Continued from page CS-36

in their late ‘70s who tell me “Chris, I don’t know if I’ll still be around in 10 years – but I do know that I can use spendable income today.” Future gains are less important to them now – they prioritize current income.

NOW YOU ARE A BETTER EDUCATED INVESTOR

Any investment offers some combination of a series of cash flow and/or appreciation potential. Now that you understand the Time Value of Money and the Concept of Opportunity Cost, you’ll be in a better position to compare different opportunities. If you have any questions, my office number is (877) 313-1868.

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1031 Risk Disclosure:

- There is no guarantee that any strategy will be successful or achieve investment objectives;
- Potential for property value loss – All real estate investments have the potential to lose value during the life of the investments;
- Change of tax status – The income stream and depreciation schedule for any investment property may affect the property owner’s income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities;
- Potential for foreclosure – All financed real estate investments have potential for foreclosure;
- Illiquidity – Because 1031 Exchanges are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Reduction or Elimination of Monthly Cash Flow Distributions – Like any investment in real estate, if a property unexpectedly loses tenants or sustains substantial damage, there is potential for suspension of cash flow distributions;
- Impact of fees/expenses – Costs associated with the transaction may impact investors’ returns and may outweigh the tax benefits