Financial Advisory

With Today's High Prices, Could it be Time to Sell and 1031 Exchange Into Better Value out of State?

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

I previously wrote an article titled "Would You Buy Your Property for What it is Worth? If Not, Why Aren't You Selling?" I was looking at local apartment listings recently, and was shocked at the extraordinary values that I saw. CAP rates in the 3% range, and GRM numbers above 20! If you have a property that you are thinking of selling "someday," perhaps today is a good time to cash in on these high values. If you, understandably, don't want to pay taxes on your gain and lose a large chunk of your principal; a 1031 Exchange is an option. But what sort of property would you want to buy as your replacement property? That is the topic of this month's article.

HIGH PRICES TODAY MAKE SELLING AN ATTRACTIVE OPTION

I am working with an investor now who bought a portfolio of properties just two years ago. Today, he is considering selling. Perhaps these properties were too management-intensive for him, possibly he just wants to cash in on a great gain, or maybe it's a bit of both. He is currently exploring a sale of these properties that could net him a gain of 20% on his investment – just from the sale proceeds alone (not including his rental income.) Not bad for such a short hold period. The "should I sell" question is the easy part in this case – a tougher question is "what should I buy as a replacement property?"

OPTION ONE – EXCHANGE INTO A LOCAL APARTMENT PROPERTY

This is everyone's first plan until they see our market conditions. A quick search for available properties here in the Los Angeles Metro area returns apartments in the 2% to 4% CAP Rate range. To review – a CAP Rate is a measure of value that tells how much an investor is paying for the NET INCOME that a property produces. A CAP Rate, however, only serves as an estimate for your return (And is probably a best-case scenario), because this measure does not include capital expenses (renovations or a roof replacement) or debt service (loan payments) costs.

Let's say that I'm looking at a 26-unit apartment complex here in the Los Angeles suburbs that is listed for $6.6 million and claims (all income figures on a listing are just claims until you have verified them)

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Christopher Miller is a Managing Director with Specialized Wealth Management in Tustin, California 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 two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

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a 4.3% CAP Rate. This means that the property produces a Net Operating Income of $6,600,000 X 4.3% = $283,800. That sounds like good annual income until you remember that it cost you over 6 ½ million dollars to get it – and that it doesn't cover management expenses, so there's a job for you in there, too.

Remember that, in a 1031 exchange, you will need to replace all of the equity and all of the debt from your old property. If you sold for $5 Million and repaid a $2 million loan, your replacement property must use your $3 million of equity PLUS a loan of at least $3 million. If you wanted to exchange into this property with your $3 million, you'd need a loan of $3.6 million to complete the deal. Since CAP Rates are 3-4% and loan rates are closer to 5% today, this means you are using negative leverage: borrowing at 5% to make 4.3% means that more of your income is going to pay the mortgage. In this example, a $3.6 million loan at 5% amortized over 30 years will have a $19,330 monthly payment, and a $232,000 annual cost. (I've rounded the numbers.) This means your $283,800 net income above becomes $51,800 annually after your loan payments – and that is a really poor return (1.73% annually) on a $3 million equity investment.

This whole discussion started with an observation of high apartment prices here locally. Sure – we could cash in and sell at these exorbitant prices, but all those gains could be wiped out when we turn around and buy another highly-priced building. Imagine if the price of automobiles skyrocketed, and your current car was worth $1 million. You could cash in and sell, but you'd still need another car. If local prices are too high for buying to make sense, does that mean we are stuck? Of course not. Let's look at some other options:

OPTION TWO – EXCHANGE INTO A PROPERTY OUT OF STATE

A quick search for available apartments in near-

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by states shows some greener pastures in the form of much more reasonable CAP Rates. However, are you comfortable with what owning property out of state comes with? How do you feel about hiring a property manager in a new town, and about property visits that require an airplane ride, a rental car and a hotel reservation? If this sounds unappealing, maybe we should look at a third option.

OPTION THREE – EXCHANGE INTO PARTIAL INTEREST PROPERTIES OUT OF STATE

For the last 18 years, this area of the investment real estate market has been my focus. We seek to bring investors the benefits, (lower prices, higher income potential, possibly higher appreciation potential) of selling their properties at what could be the top of the "value wave" here in California and exchanging into a state where this value wave may just be beginning to swell. Rather than looking at 10, 20 or 30 apartment units, my investors can buy part of a professionally-managed 300-unit apartment complex in a growing metropolitan area such as Dallas or Atlanta. Alternatively; rather that buying all of a franchise operated Kentucky Fried Chicken, my clients can buy part of a portfolio of Triple Net Leased properties that are leased long-term to publicly-traded, credit-rated companies. If the thought of "selling high" in California's sky-high market and "buying low" out of state appeals to you, then perhaps the properties I represent are worth learning about. I can be reached toll-free at (877) 313-1868.

While there are many benefits to 1031 Exchanges, there are strict timing limitations. Specifically, if a 1031 exchange transaction is not properly constructed and executed in a timely manner, then an investor may lose all tax benefits of such transaction, including depreciation recapture. The relinquished property must be a qualifying property (i.e., like-kind replacement property). A Qualified Intermediary, as an independent third party, is needed to facilitate a 1031 exchange transaction and hold the funds on behalf of the investor.

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. 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, began working in the partial interest industry in 2001 and has been a broker advising clients since 2003. Call him toll-free at (877) 313 – 1868.

What Is.. Your Investment Property's *Cash on Cash Return?*

Would you put your money in a bank account at a low interest rate? Probably not, but many investors are doing just that with their investment properties. Although property values have increased dramatically, income has not for many investors.

Try This- Calculate your Cash on Cash return.

Yearly Income - _______(subtract) Expenses ______(subtract) loan payments _______

= Annual Cash Flow ______________

Now, estimate your property's value___________ (subtract) Loan Balance__________

= Your Equity Value ______________

Now, divide your Annual Cash Flow by your equity value, and you get your

Cash on Cash Return % _____________ .

Want to increase your properties' income potential?
Call Chris Miller at **877-313-1868** today!