FINANCIAL ADVISORY

The Three Most Important Things About Real Estate Aren't What "They" Tell You

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

We have all heard innumerable times that the three most important things in real estate are "location, location, location." This month's article will explain that this advice is completely wrong and discuss how following it can cause severe financial damage. I'll also suggest that any "real estate expert" who utters the phrase "location, location, location" really isn't one – or they're just trying to sell you something.

There are actually four most important things in real estate. They are:

1. **LOCATION**
2. **PRICE**
3. **TIMING**
4. **INCOME**

Location is still an important characteristic of real estate; it's just not the only important factor when evaluating it. It's probably not even the most important characteristic, either. Plenty of people have gone broke while buying properties in great locations. While these four variables may not be equal in importance, if you buy a property with "bad" location, price, timing OR income; you'll suffer financially.

WHO HAS SUFFERED FROM BUYING PROPERTIES IN GREAT LOCATIONS?

You may remember the Japanese were buying a lot of US properties in the 1980's. Golf Tycoon Minoru Isutani paid $841 million for the Pebble Beach Golf course in 1990. Amid cash flow problems, which may have been exacerbated by the recession of that time, he sold the property just two years later for $500 million. At the time, Mr. Minoru was focused on the location: beautiful Pebble Beach. The course is famous, scenic and irreplaceable. The price he paid was too high, one that the property's cash flow couldn't support, and he lost big.

Similarly; Mitsubishi Estate purchased a 51% stake in New York City's Rockefeller Center in 1989 for $846 million of cash and assumed that percentage of the property's $1.3 billion loan. How could they lose with such a great location and low leverage? ($846 million equity and $663 million debt = 44% loan to value) They didn't pay

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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.

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attention to the property's income. In 1992, the building lost $50 million. This staggering shortfall grew to $61 million in 1993 and $139 million in 1994. Mitsubishi broke two of the 4 rules (too high a price, too low income) in their purchase and, not surprisingly, gave the property back to the lender after a Chapter 11 filing in 1995.

LOCATION

This rule is pretty self-explanatory. Your property needs to be near those who will use it. A mall must be near suitable pockets of disposable income, while an apartment complex needs to be where people will want to live. Office buildings must be in close proximity to places where employees and customers live. Gas stations need to be on well-travelled roads and in spots that are easy to access, and boat rental shops need to be on the water.

PRICE

Many experts, myself included, believe that "you make your money on the purchase, not the sale of real estate." Paying too much for a property will cut into your profit when it is time to sell. Additionally; a higher sales price generally requires a higher loan amount – with a higher (and harder to make) monthly payment.

TIMING

Timing is also a crucial factor in the purchase of real estate. This is not trying to "time the market" and buy at the very bottom and sell at the peak. Timing, instead, refers to buying in the right set of circumstances. Buying in Raleigh, North Carolina as the market there is continuing to expand may be preferable to buying a GM assembly plant in Detroit as that city has been declining for decades.

The right set of circumstances means areas that are poised for growth in the future. As I often say, Orange County has probably done all the explosive growth that's possible; but other areas in the country are poised for similar transformations over the next decade.

INCOME

Commercial real estate is priced based on the income it produces, so income is the most important thing about any property you're evaluating. While reviewing a potential purchase, take a look at the rent roll. Are the rents you are receiving above market? If so; they'll be replaced by market (lower) rates when those leases roll over – meaning a lower value and less income for a landlord. If your property has a long term lease, how strong is the tenant? There are several retailers signing 70 year leases today who are strong tenants today – will they be that way in 30 years? Remember: Sears was a strong company 30 years ago.

For those properties with long leases, you'll need to find out how your income will grow. Remember, again, that your property is valued based on the income it produces. No income growth will mean no value growth. In fact, due to the effect of inflation, a property with no income growth will shrink in value.

WHEN BUYING REAL ESTATE, THE "BIGGER PICTURE" COUNTS

Now you know why "location, location, location" is NOT all that matters when buying real estate. By applying some of the principles from this article to your own due diligence process, you'll be able to look more objectively at potential investments; and more likely to find success.

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- 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