



Sphynx Financial

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The Real Return on Real Estate

Stock market investors are often so focused on growth, that many do not realize how the leverage, cash flow and tax deferral of real estate investing can combine to produce potent returns. And when mixed with the power of compounding, real wealth can be generated from a relatively modest investment.

The real return on real estate is not always easy to see, which is perhaps why investors do not pursue it as actively as investments in equities or fixed income instruments. And professionals do not always agree on the best way to calculate the ultimate return on real estate. Here's an approach which takes into account the cash flow, tax equivalent yields and depreciation on a combined as well as a separate basis that can make the case for why you might consider investing in real estate.

Throughout this example, we'll take some shortcuts that make our numbers conservative. If this case study was real, the actual return would likely be higher than what we present. These short cuts will be pointed out as we go along.

Consider our happy fictional couple, the Smiths, who purchase a four unit apartment building in their town for \$292,500. Their down payment is \$75,500, or 25%, and their closing costs are another \$6,822 for a total cash investment of \$82,322. Their total mortgage balance, with one point on top is \$219,170, financed with a 6.26%, 30 year mortgage.

During the first year of ownership the Smith's building delivers the following financial performance:

Total Rental Income - \$40,780
Mortgage Payments - \$16,210
Gross Income - \$24,570
Operating Expenses - \$19,836
Net Cashflow - \$ 4,734

Here is the first of the short cuts. The "Mortgage Payments" include principal as well as interest. The interest expense alone is less than the \$16,210, meaning the net income and the investor's return is higher than what we will shortly calculate. We will revisit this later.

At the most fundamental level, the investor's return is 5.75%, consisting of \$4,734 cashflow divided by the \$82,322 total equity investment. Scholars might quibble with whether or not closing costs ought to be part of the calculation. If not, the return goes up to 6.27%. However, for those who actually had to come up with the cash to get to the closing table, it's easy to look at these expenses as part of your equity in the property.

A return of 5.77% is not such a bad thing, but at the same time, it is not quite a compelling thing either. Yes it will double in 12 years, but that's a long time. However, 5.77% is not the end of the story, but rather, the beginning of the story.



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Enter depreciation. Most rental property can be depreciated over a lifespan of 27.5 years. Therefore, the \$292,500, net of the land value of \$5,100, carries an annual depreciation expense of \$10,451.

This is a non cash expense, which is the best kind to have because it will significantly boost the Smith's return. Why? Because on an economic basis, the Smith's property actually lost \$5,717. (\$4,734 operating income - \$10,451 depreciation). Therefore the \$4,734 that went into the Smith's pocket is sheltered from taxes by the depreciation on the property.

For the Smith's to put \$4,734 in their pocket from wages, tips and salary they would have to earn \$7,283 in a 35% tax bracket. Therefore the so-called tax equivalent return is 8.85%. (\$7,283/\$82,322). Now the Smiths are getting somewhere. And once again, this figure understates the return because it does not take into account the sheltering of income against state and local taxes which might occur.

But there's more. The Smith's still have an economic loss of \$5,717, which is the depreciation expense net of the operating cashflow. (\$4,734 - \$10,451). This loss will help the Smith's shelter \$5,716 of other income. Specifically, if the Smiths are in the 35% tax bracket, the \$5,716 loss on their property will result in \$2,001 of avoided federal income taxes. If this avoided expense is viewed as income, it represents an additional 2.43% return (\$2,000/\$82,322) in addition to state and local taxes which may have been avoided as well.

As an aside, the opportunity to avoid taxes through real estate investments can be tricky. Specifically, if you are not a real estate professional, i.e., it is not your career, the federal government places a limitation on how much of your passive loss from an investment on something such as real estate can be thrown against your ordinary income. Specifically, a married couple filing jointly may offset up to \$25,000 of passive losses against their "active" income, such as wages and salary. Further, the deduction is phased out between adjusted gross incomes between \$100,000 and \$200,000.

And while we are on the subject of taxes, it's worth noting that some of the deferred income taxes will come out in the wash in the form of higher capital gains taxes if and when the property is sold. This will happen because the depreciation expense decreases the owners' basis in the property, which will increase their gain upon sale.

In the case of the Smith's, neither limitation applies. Accordingly, the Smith's return is 11.28%, which is comprised of their 8.85% taxable equivalent yield plus the 2.43% yield from avoided taxes. While this figure takes some work to arrive at, there's nothing illusory about it. You would have to generate interest income of \$9,286 on an investment of \$82,322 to come out the same after taxes.

There is one other element to the return worth taking into account. The monthly mortgage payments consist of interest and principal. During the first year of operation, the Smith's pay \$13,647 of interest while making \$2,563 in principal payments.



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There are several ways of looking at this \$2,563. One way would be to add it to the equity base of \$82,322, since principal payments add to owner's equity. This has the effect of decreasing percentage returns, since additions to equity increase the denominator of return calculations.

But this is not the appropriate way to consider this new sliver of equity. The reason for this has to do with pockets. Specifically, since the mortgage is a self liquidating liability funded by tenants' rental payments - assuming of course at least break even cash flow - this new equity never came from the owner's pocket. It came from the tenants'. Therefore, it's not unreasonable to think of this \$2,563 as a gift, which at 3.11% of the initial \$82,322 investment, is not an insignificant one. If it could be efficiently extracted from the property, this \$2,563 could also be viewed as a return of principal which reduces the owner's equity investment from \$82,322 to \$79,759, which in turn, will increase the 11.28% effective return.

If there has been any appreciation in the value of the property, the owner's equity will increase even faster than the rate at which principal is "gifted" to the owners by the tenants.

Of course real estate investing is not as cut and dried as this article would make it appear. Owning a building where others live is a real responsibility. Things do go wrong. Maintenance is required. But if you've got the temperament for it, the very real return on real estate can be well worth your time and attention.
