MARKET MONITOR

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Bottom Line for Real Estate is its Return on Investment (Part 2)

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Property Development	Paseo	Mirage Crossing	Harvest Hills	Signature Club
Location	Fort Myers, FL	Scottsdale, AZ	Saint Charles, IL	Naperville, IL
Purchase Price	$260,000	$300,000	$229,000	$254,000
Loan Amount (80%)	$208,000	$240,000	$183,200	$203,200
		Revenue		
Rental Income	$26,250	$25,000	$23,400	$25,200
		Expenses		
Principal & Int	$12,650	$14,600	$11,140	$12,355
Taxes	$5,600	$1,375	$4,833	$4,625
HOA- Dues	$7,236	$3,180	$2,316	$2,400
Utilities	$2,400	$2,400	$2,400	$2,400
Maintenance	$2,400	$2,400	$2,400	$2,400
Insurance	$1,200	$1,200	$1,200	$1,200
Vacancy Allow	$0	$0	$1,950	$2,100
Total Cash Outlays	$31,486	$25,155	$26,239	$27,480
		Earnings		
Profit/(loss)*	($1,946)	$3,645	$57	$931
		Ratios		
Debt Coverage Ratio	.59X	.99X	.75X	.82X
Return on Equity	-3.74%	6.07%	0.12%	1.83%

**profit and loss numbers exclude the principal portion of loan payments interest rate assumed at 4.5%*

Picking up where we left off in the last issue of Market Monitor, let's assume that you're an Illinois resident and you think you might want to buy a property in a resort area to rent now and occupy in retirement or maybe you want to buy a property somewhere nearby your home in the Chicagoland area. Or you could go all in and by all four properties that are part of this comparison in hopes that they'll generate enough income to fund your retirement or supplement your current salary.

Recall that in Part 1 of this analysis I mentioned that real estate is an asset class where purchase price is very important. The reason being is that real estate is considered to be an inefficient market. This means that information in the market is not readily accessible to all buyers and sellers. In other words, buyers and sellers with more knowledge about a market have a distinct advantage over others who have less knowledge and expertise. So before you go out to Arizona or down to Florida know that the insiders, like the local real estate brokers in those markets, have the edge. The same can be said about your own town. Unless you develop a real grassroots feel for a market, you may simply be relying on good fortune to stumble into a profitable deal.

Fortunately the inserted chart offers you the tool to take any transaction and analyze its financial strengths before you commit major dollars to the investment.

Starting from the top you see four properties in different real estate markets. Next in the chart are the purchase prices and loan amounts assuming you secure financing for 80% of each property's value. My banker friends tell me that they like to finance real estate investment transactions that have positive cash flows so rental income, less expenses must be sufficient to repay debt. Securing financing is not a forgone conclusion for any of these specific properties, because they all have weak debt coverage ratios.

Although real estate is a market with less than full efficiency, it's less of a

See "Avoid Bad Choices" page 2

Know Revenues Less Expenses to Avoid Bad Choices in Inefficient Real Estate Market

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problem today than it was prior to the Internet age. For instance, the assumed rental incomes are calculated based upon information taken from Vacation Rentals By Owners (VRBO) and local real estate websites that offer a quick means of finding local average rental rates.

The Illinois properties base rental income on an entire year and the resort properties assume five months of rental income during peak months, which should be considered an optimistic assumption. HOA and taxes are expenses that are close to fully accurate while utilities and insurance are best estimates. The vacancy allowance for the resort properties is built-in to the numbers by using only a five month rental period, but for the Illinois properties an allowance of one month's rent is used, which is hopefully a reasonable average over a longer term period of about five years.

Essentially, what you end up with is three properties that offer you no positive cash flow which is calculated by subtracting cash outlays from rental revenue and the AZ condo is just a whisker above breakeven. Using these numbers it would be impossible for any property that carries a loan to offer any supplemental salary or retirement income streams. Also, no property is particularly attractive to a lender to offer you financing. Unless the lenders are willing to include your income from other sources, because the individual properties are unable to stand on their own with debt coverage ratios all under 1X. Lenders usually like debt coverage ratios with cushions or something around maybe 1.1X.

From this analysis you have to conclude that the Scottsdale property offers some hope but it might require you to have a much higher down payment or to pay cash because its cash flow is not strong for loan purposes. Its ROE is good but you have to ask whether the return is sufficient for the amount of effort and risk you take for making the investment. This is true even if you add an assumed rate for capital appreciation of 3%, because when you go to sell the property you'll incur some stiff brokerage commissions that can swallow a good chunk of your capital gain.

It's possible that real estate prices have increased to the point where they don't reflect a good value, or it's just that the properties selected for this analysis all happen to be weak for investment purposes. This might be the case but that's why scouring the market by collecting data and doing the calculations in an inefficient market is required before you pull the trigger on a purchase.

Market Snapshot:

Less Hawkish Fed and Prospects for Trade and Budget Deals Lift Market

By: Michael Alexenko, CFA

Federal Reserve policy was likely the greatest obstacle for the market entering 2019. The Fed chairman made some cautious statements about slowing the pace of interest rate increases which was a big relief for the market. Everyone agrees that our economy and the bull market are in the late stages of their normal cycles which make them most vulnerable to policy errors. The Federal Reserve wisely concluded that further aggressive monetary tightening which included the shrinking of its balance sheet could push the economy into recession. The Fed's actions had caused the partial inversion of the bond yield curve which means we can't rule out that enough damage has already been done increasing risks for recession within the next 12 to 24 months. Other welcome news is the potential avoidance of extending the government shutdown and some progress in reaching agreement with China on trade. Small companies (measured by the Russell 2000 index) need to continue to outperform this year. They lost ground last year and we all know how the story ended in 2018. Small companies are often good indicators for the broader market