Can You Double You Money with Single Family Homes?

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By now, everyone has seen articles in the national media about the business of purchasing homes at depressed values and holding them as rental properties. This investment strategy received an endorsement from none other than Warren Buffett recently on CNBC when he stated that he would like to buy a large quantity of homes, using leverage, and rent them out to generate income while waiting for home values to recover. Demand from tenants is strong today because many families have lost their home, resulting in what some analysts are calling the advent of a "rentership society."

Estimating Potential Returns: A Simple Model

Like apartment buildings, portfolios of rented homes lend themselves to the use of debt financing because they generate a predictable stream of income. By using 50% leverage, capable investors who understand this business could indeed double their equity over five to seven years. Of the total return, about one third comes from rental income; one third comes from appreciation (assuming 3.5% appreciation per year); and the balance comes from initial value creation by purchasing the home from a bank and renovating it cost-effectively.

Return from Rental Income. Let's assume that an investor purchases a home for $180,000 and spends $20,000 renovating the home. The total cost is $200,000. The home is rented for $1,800 per month or $20,000 per year (assuming about one month of vacancy per year). Let's assume $7,000 per year of operating expenses, including property taxes, insurance, repairs and maintenance, property management expense and reserves. That leaves $13,000 per year of income, representing a 6.5% yield as compared to the total cost of the property. Over a six-year holding period, at 6.5% per year, the investor receives a 39% total return on capital. (In practice, we will be using some leverage but for simplicity we will assume a 6.5% interest rate on the loan, so that the leveraged return on equity is the same as the unleveraged return).

Return from Appreciation. Let's say home values rise 3.5% per year during the six year holding period. A $200,000 house increases in value to $207,000 in the first year, then to $214,245 in the second year, and so on, until the value reaches about $246,000 in the sixth year. Suppose we sell the property at the end of the sixth year, incurring a 7% selling cost to pay a realtor and other closing costs. The net proceeds are about $229,000. Recall that we are using a loan of $100,000, so when we compare the $29,000 profit to our equity investment of $100,000, that's about a 29% return from appreciation over six years.

Return from Initial Value Creation. Banks currently own or otherwise control millions of homes. Most of these homes need renovation before they will qualify for traditional financing, and banks are not in the business of choosing paint colors or replacing worn out carpet. As a result, opportunistic investors who buy properties from banks usually purchase these properties at "wholesale"

prices rather than "retail" prices. To put it another way, if an expert buyer purchase a property from a bank and renovates it cost-effectively, he or she should be able to create value within the first 90 days of ownership. Roughly half that value might be attributable to buying the property for all cash from a motivated seller, and the other half comes from increasing the property value by $1.50 or $2.00 for every $1.00 of money spent on renovation. Between these two effects, our investor who purchases a home for $180,000 and spends $20,000 on renovation should be able to create $40,000 of value, assuming a fair market retail value of $240,000, once the home is renovated. Note that we are not accounting for selling costs in this portion of the analysis, since they were counted in the appreciation section. The numbers are not meant to be precise, only to give an idea of potential returns. Comparing our $40,000 of initial value creation to our equity investment of $100,000, we have a 40% return from value creation.

Adding the three components of return yields 39%+29%+40%=108%. In other words, our $100,000 investment turned into about $208,000 over six years.

For Most Investors, It Isn't That Simple

Any time someone says you can double your money, a large dose of skepticism is appropriate. In this case, there are a number of real world challenges that explain why not everyone is rushing to buy and rent single family homes.

It's a Lot of Work. Being a landlord is not for everyone. If a pipe breaks and the house is getting flooded, your tenant will call and you will need to get a plumber to the property right away. This issue alone means that most high net worth investors would probably rather have someone else managing any investment they make in single family homes. Of course that manager will need to be paid, which will reduce returns.

Managing Rental Homes is Harder than Apartment Buildings. With an apartment building, investors enjoy many economies of scale not available in single family homes. For example, all the units in an apartment building can share the same appliances, air conditioning units and a common on-site manager. In a portfolio of houses, the appliances and air conditioning units might all be different, making maintenance more complex. There is no way to have an on-site manager, so it is harder to monitor how the tenant is treating the property.

The Housing Market Might Drop Further. The U.S. housing market is weak and prices have been dropping. Millions of forthcoming foreclosures could force prices even lower, so that the appreciation portion of returns may never materialize.

This last concern is one I hear frequently from investors. Personally, I believe the U.S. housing market is very near a bottom. We have been purchasing houses for 50-70% below their peak value. Frequently our purchase price is less than half of what it would cost to build a new, similar house, because new home builders need to pay tens of thousands of dollars in local fees and site improvement costs to build a house, even if they could buy the land for nothing.

In summary, many of the world's top investors, including Warren Buffett, are enthusiastic about purchasing U.S. homes for a good reason. They are historically cheap, rental demand is strong, and they lend themselves to leverage which could enhance returns substantially.

