Is Now The Time To Purchase Residential Income Property?

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Let’s face it. The last few decades some **very interesting** events have occurred when it comes to buying and selling real estate. There have been people who lost a lot of money and people who have made a lot of money. There are also people who want to do something but are sitting on the sidelines lacking the knowledge and confidence to make a decision.

So how do you decide if and when you should enter the real estate market to purchase an investment property?

This is a great question and I will try answering it by teaching you principles that reduce the risks involved and increase the yields that can be obtained.

WHAT FACTORS HAVE AN INFLUENCE ON THE PRICE OR REAL ESTATE?

SUPPLY AND DEMAND.

Of course, this is the major cause of price fluctuations. If there is a lot of inventory and few buyers, sellers will have to be more competitive with their prices. If there are lots of buyers and few sellers, owners can hold out for the highest price possible.

So what factors influence supply and demand?

1. The expansion and contraction of the economy
2. Interest rates
3. Changes in tax laws
4. The cost of labor and material
5. Consumer confidence
6. Inflation
7. Population trends
8. Qualification requirements of lenders

WHAT IS LEVERAGE?

"The first reason people struggle financially is because they mismanage their money. The second reason is that they fail to leverage their money." – Robert Kiyosaki, "Rich Dad – Poor Dad"

Most real estate fortunes are made today because of the power of leverage.

There are two types of leverage in real estate investing.

The first type can be good, bad or neutral.

The second can also be good, bad or neutral but for completely different reasons.

So what is leverage? Leverage is the ability to control an asset with a small amount of your money invested.

LEVERAGE #1
BASED ON THE PROPERTY APPRECIATING
A NET WORTH ASSET

This type of leverage becomes very powerful when an asset appreciates in value. When this happens your yield is compounded.

Example: You purchase a triplex for $100,000 with a $20,000 down payment and obtain a new loan for $80,000. After one year, the property has increased in value by 5% to $105,000.

Your yield for the year would be:

$5000 ÷ $20000 = 25%.

That is a pretty good return on investment. But what happens if the property does not appreciate at all. Your yield would be

0 ÷ $20,000 = 0%

That's not too exciting.

It can even get worse. What happens if the property goes down 5%. It would result in you losing $5000 of your equity and your yield would be

($5000) ÷ $20,000 = - 25%

Of course, real estate always goes up in value, right? That is why we have so many bank owned properties for sale, and why so many properties are upside down (they owe more on the property than the property is worth)

THE PROBLEM WITH LEVERAGE #1

Leverage #1 cannot be counted on. A lot of speculators purchase assets, including real estate with the hope of appreciation. However, most assets that you purchase do not have a monthly expense associated with them. Residential income property can have a large monthly payment. Some people purchase property with big negative cash flows and then compound the problem with poor management. The end result is that they run out of money and want to stop the bleeding. They end up selling or losing the property by foreclosure with a giant painful loss.

You do increase your chances of success with Leverage #1 if you buy when the market is low.

LEVERAGE #2 – USING THE ART AND BILL MODEL
A CASH FLOW ASSET

The Art and Bill model is something that I developed to show investors another use of leverage. I explain it in almost all my material. It is not based on appreciation. It is based on the goal of purchasing residential income property that produces cash flow.

ART

Art is a multi-billionaire. I will introduce you to Art and he is willing to lend you as much money as you want at 8% interest. The loan will be unsecured and you will start making interest only payments monthly with the first payment due 30 days after you receive the money.
8% is pretty high interest!

How much money do you want to borrow from Art?

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BILL

Bill is America's safest borrower. He always pays the money he borrows back. He is willing to borrow as much money as he can at 12% interest. I will introduce you to Bill.

Now how much money do you want to borrow from Art and loan to Bill?

You should answer a very large number! So what is happening here? You would be making cash flow on borrowed money. If you borrowed $10,000 from Art at 8%, you would make monthly payments of $66.67. If you then turn around and loan it to Bill at 12%, you will receive a payment of $100.00 per month. You would get to keep $33.33 every month without risking your own money. **You earned 4% on borrowed money.**

Let me ask you: **What is your yield on this transaction?** Just about everybody will answer 4%? That answer is INCORRECT! How much of your personal money do you have invested in this transaction? $0.00! Your yield is actually **INFINITE**!

Art is a symbol for a lender. It is the entity that you will borrow money from at a certain interest rate. Bill is a symbol of a property that you can buy. If it were free and clear of loans, you would receive yearly gross income, pay expenses except for any mortgage payment because the property has no loan, and you would end up with a net yearly cash flow (net operating income) on the property. If you take the net income and divide it by the value of the property, you will get a number, called a **CAP RATE**. In other words, a **CAP RATE** is the rate of return from the cash flow on a property if you owned it free and clear.

ART AND BILL IN ACTION

Let's look at some scenarios to see the effect of the Art and Bill model to help us use Leverage #2 to build cash flow.

First of all I want to redefine an important term – CAP RATE
Cap Rate – is the return you get if you own a property free and clear.

Example: On January 1st, you purchase a property for $100,000 and pay all cash. On December 31, you found that you have collected $16,500 in rents and you paid $5,500 in expenses. Your net income for the year would be $11,000. Your cap rate would be:

$11,000 Net income ÷ $100,000 Down Payment = 11% cap rate

Case Study: You buy a piece of property for $100,000 with $20,000 down payment and a new loan for $80,000. Remember in Art and Bill, you earn the difference in the interest rate from what you get and what you pay.

Case #1 Interest rate = 8% Cap rate = 11%

3%	**11%**

You would earn 3% on $80,000 plus 11% on $20,000
$2400 + $2200 = $4600 $4600 ÷ $20,000 = **23% yield**

Case #2 Interest rate = 8% Cap rate = 8%

0%	**8%**

You would earn 0% on $80,000 plus 8% on $20,000
$0 + $1600 = $1600 $1600 ÷ $20,000 = **8% yield**

Case #3 Interest rate = 8% Cap rate = 6%

-2%	**6%**

You would lose 2% on $80,000 and make 6% on $20,000
—$1600 + $1200 = —$400 —$400 ÷ $20,000 = —2% yield

CONCLUSION: THE GREATER THE POSITIVE DIFFERENCE BETWEEN THE CAP RATE AND THE INTEREST RATE, THE GREATER THE CASH FLOW AND THE YIELD – ART AND BILL.

WHAT IS THE RISK OF THE ART AND BILL MODEL?

You would think that if you analyzed a property and determined the Cap Rate was larger than the interest rate and you would have positive cash flow, it wouldn't matter if the property went up or down in value, you would still have a nice cash-on-cash return. However there are two problems.

Problem #1 – How accurate were the figures used to determine the CAP RATE. Numbers are only as accurate as the expertise of the person creating them. If your interest rate is 7% and you figure a CAP RATE of 10% and then after the first year of ownership, you determine that the CAP RATE was actually 6%, you won't be happy.

Problem #2 – The CAP RATE is determined using a management model based on a certain amount of competence. If the actual management is inferior, you automatically will have a lower CAP RATE.

A lot of purchasers end up with a bad situation because their real estate agent did not know how to accurately determine the CAP RATE and the buyer didn't know how to manage the property himself or picked a management company that under performed.

SO WHEN IS THE ABSOLUTE BEST TIME TO BUY RESIDENTIAL INCOME PROPERTY?

Leverage #1 – When the prices of property are below market..

Leverage #2 - If you use the Art and Bill Model, the time to purchase income producing real estate is when our Art and Bill ratio is a nice positive number. This is usually when everyone thinks it's a bad time to buy real estate, when there are a lot less buyers than sellers. This is the time when you can find motivated owners.

Ex: Cap Rate 7% Interest rate 6% - Bad Time to Invest,

Ex: Cap Rate 13% Interest Rate 9% - Good Time to Invest

WHAT'S GOING ON IN THE REAL ESTATE MARKET TODAY?

I have been investing in residential income property since 1976. I have seen all kinds of markets.

For you to have a successful experience investing in residential income property you need to learn what is going on with Cap Rates right now and what is going on with Interest Rates right now.

The best way to do this is to find a knowledgeable residential income property specialist to join your Master Mind Group who can help you get up to date with the market.

To learn more about how to become a professional real estate investor and significantly increase your chances of success, I encourage you to go to our website where you can have **FREE** access to our seminars, books, and reports.

www.BakersfieldIncomeProperties.com

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