

The Single-Family House

Excerpt from [*Mastering Real Estate Investment: Examples, Metrics and Case Studies*](#) by Frank Gallinelli
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Many real estate investors, especially those who are just starting out, gravitate to single-family properties.

Throughout this book so far you've been serenaded with tales of apartment building and office building and shopping center investments. But the single-family is the square peg in our story. How is it different and why do people buy it as an investment?

Let's take the second question first. There have probably been no formal studies on this question, but this writer has some opinions on the subject and it was, of course, to hear such opinions that you bought this book.

Familiarity is surely the first and main reason. You probably already own a single-family house, and perhaps you grew up in one. You believe that you at least understand this type of property; you've gone through the financing drill and the closing. You feel more comfortable with what you know.

For some people, the opportunity to lust after quick riches may provide a second and compelling motivation. You've heard stories and seen books and infomercials about regular folks just like you and me who have bought a house and "flipped" it in days or weeks, making tens of thousands of dollars in profit. And then they did it again. Buy it before breakfast, sell it before lunch.

A lot of people made a lot of money doing this. Eventually, a lot of people also lost a lot of money doing this. You probably didn't hear as much from the latter because they didn't get as many book deals.

Flipping is a form of speculation, predicated on the assumption that property values are going to rise, often spectacularly. Many flippers think that home prices always go up, everywhere – or at least they thought so until about 2007. When speculators take over a market, sooner or later bad things are going to happen. If the rise in values in a particular location is driven by speculation rather than by the underlying economics of the community, eventually the music is going to stop and there are going to be very few chairs left. This is not investing.

You should recognize that investing is a program for the long-term building of wealth, and it has little or nothing to do with speculation.

Let's assume now that you have taken these warnings to heart, have avoided any area touched by speculators, and still wish to invest in and rent out a single-family house, a nice property nestled among a neighborhood of owner-occupied homes. How do you go about evaluating this property's investment potential?

You should start out by being aware that there are a few characteristics of single-family properties that differentiate them from apartment buildings, office buildings, shopping centers and other more typical income-producing properties.

One of these characteristics is density, or really the lack of it – specifically, the relationship between the number of rental units and the cost of the land. Say that you buy a ten-unit apartment building. It sits on a piece of land, and you apportion the cost of that land over 10 rent-producing units. If you buy a one-family house, you apportion the cost of the land over just one rental unit.

Obviously this is an oversimplification. The cost of the land isn't necessarily the same between the two properties. Then again, the single-family lot could easily be *more* expensive than the parcel on which the apartment building sits. Oversimplification or not, a general alert is in order. You may have a difficult time earning enough rent income from just one unit to carry the cost of the land as well as the building, since that cost per unit may be disproportionately high. In short, don't be terribly surprised if you have a hard time getting a positive cash flow from a single-family house used as a rental property. In contrast, a single condominium unit, which in most respects behaves like a single-family house investment, may disperse the cost of the land across a greater number of units.

A second and very important characteristic of this type of rental property investment is that its value is not likely to be a function of its ability to produce rent.

If the other houses in the neighborhood are being bought and sold as personal residences, then the prices in that community will be driven by the market for such residences, not by potential rental income. In other words, when you buy this property you will pay a price based on what people are paying for homes in the area; and when you sell it you can expect a price driven by that same market.

The market data approach to value is based on comparable sales. You can reasonably expect that a property will sell for something close to the price of similar properties located near the subject, i.e., comparables located in the same market. You would of course make adjustments for distinguishing features — the presence or absence of certain amenities found in the comparable properties — but it is the local market as much if not more than the property itself that drives the value.

There is a related characteristic that differentiates the single-family house from other income-property investments. When a property's value is a function of its income stream (as with typical commercial properties, apartment buildings, etc.), then you as an investor have the opportunity to create value by enhancing that income stream. You might be able to impose management improvements that allow you to enjoy higher rental income and less vacancy. Your active and inspired management increases the property's Net Operating Income and hence its value. You create equity.

On the other hand, if you purchase a single-family house for investment, you may be able to increase its value by making physical improvements, but you can't raise its value by improving its NOI. And in the back of your mind you know that those physical improvements might not return more than they cost, and they might not even survive cohabitation with tenants.

The difference, then, is in the degree to which you can personally influence the ultimate success of your investment. With a conventional income property you can have an impact on value, but with a single-family you must usually rely on general market conditions, over which you have little influence.

Even though the price at which you buy and the price at which you sell will not be a function of the property's rental income, you can still perform cash flow and resale projections, still estimate your rate of return, and still make a judgment as to whether or not this looks like it will be a successful investment.

The house may not be an income property in the purest sense, but that is how you're using it. You're buying an income stream and you need to estimate how much you can expect in the way of yearly cash flows and how much you'll derive from the final cash flow, the proceeds of sale. That's what investment analysis is all about. Let's see how it's done.

The Facts:

On January 1, 2011 you plan to close on the purchase of a 1,900 square foot single-family house for \$179,000 with a 20% down payment. Your mortgage has a fixed rate of 6.75% for 30 years.

According to the tax assessor, 75% of the value of this property lies in the building and 25% in the land.

You believe it will take you two months to find a tenant who will pay \$1,200 per month. During those two months you plan to go in and spend \$1,800 on paint and some minor repairs to get the place looking good. You plan to budget \$600 for repairs in the second year, and to increase that budget by 3% each year thereafter.

You assume that you'll be able to raise the rent in subsequent years, and figure that a 3% annual bump will probably be close to the increase in the overall cost of living.

The tenant will arrange for and pay all of his own utilities, including water. However, you decide that you don't want to rely on your tenant to cut the grass or shovel snow from the sidewalk – if he doesn't do it, the place will look like a disgrace – so you keep that responsibility for yourself. You budget for five snowstorms at \$35 each and 12 lawn cuts at \$20 each, and you assume that this expense will go up by about 5% per year.

Annual property taxes are currently \$2,300 and have been rising at about 4% per year. Property insurance will cost you \$900, and to be conservative you estimate that it will cost you 5% more each year.

You would like to keep the property for no more than five years. The biggest unknown, of course, is what will it be worth then? You decide to role-play several different possibilities. What if home prices stay flat for five years? What if they go up 3% per year? 6% per year? When you sell, you assume it will cost about 7% for the services of a broker and attorney.

One scenario you won't test is the possibility that values will decline. It's not impossible for that to happen, of course, but you certainly don't need to go through the exercise of an investment analysis to tell you that you would lose money. If you thought the value of this property was headed down, you wouldn't (or certainly shouldn't) be buying it. You believe that the worst-case scenario for this market at this time is a flat five years.

You want to estimate your rent and expenses over time, as well as your cash flow. You want to see how well you'll do if you sell at the end of five years. But what if you have a family emergency? Could you bail out after two or three years without losing money?

You have a lot to think about.

Since this is your first detailed exercise, I must tell you in the spirit of full disclosure that for each case study I'm going to use one or another of my company's software products to perform the analysis and display the results to you, sometimes with exhibits trimmed down a bit to eliminate issues not dealt with in the problem. That doesn't mean you have to use those products too. You can use a pencil and paper and calculator, or you can build a spreadsheet to work with just the facts of the problem, or use some other software application, or take whatever approach suits you. The main focus here will not be, as in the first half of the book, on how to do the math, although you'll still see your share of numbers. And it will not be on how to run a particular software program. It will be about how to look at and think about the results.

The Analysis:

Let's begin by looking at the Annual Property Operating Data, extended over five years.

	2011	2012	2013	2014	2015
INCOME					
Gross Scheduled Rent Income	14,400	14,832	15,277	15,735	16,207
TOTAL GROSS INCOME	14,400	14,832	15,277	15,735	16,207
VACANCY & CREDIT ALLOWANCE	2,400	0	0	0	0
GROSS OPERATING INCOME	12,000	14,832	15,277	15,735	16,207
EXPENSES					
Insurance (fire and liability)	900	945	992	1,042	1,094
Lawn/Snow	415	436	458	481	505
Repairs and Maintenance	1,800	600	618	637	656
Taxes					
Real Estate	2,300	2,392	2,488	2,588	2,692
TOTAL EXPENSES	5,415	4,373	4,556	4,748	4,947
NET OPERATING INCOME	6,585	10,459	10,721	10,987	11,260

What is this APOD telling you about the investment? First and most striking is that you'd better keep your expectations in check during the first year. You anticipate losing two months' rent and plan to spend about three times your normal budget for repairs and maintenance, leaving your 2011 NOI depleted.

Things look a little better thereafter. Or do they? Remember our discussion above, about how the value of a single-family house would probably not be a function of its ability to produce income. Clearly, that seems true here. After the atypical first year, the property's NOI stabilizes in the \$10k to \$11k range. If you apply a 10% capitalization rate to those NOIs you would get a value estimate between \$100,000 and \$110,000, quite different from your \$179,000 purchase price. (Although 10% may not be precisely the right rate for this market, cap rates have historically clustered between 8% and 12%, so 10% is a nice round number for making a rough estimate, and it has the advantage of allowing you to do the math in your head.)

As you begin to clutch your chest and tumble to the floor, you recall that whoever buys this property from you in the future will also pay based on its value as a home and not on its capitalized income. So, while the NOI would typically be very important to you as a determinant of value with other types of income property, with the single-family house its main significance is as a stepping stone to your calculation of cash flow.

Another issue that jumps off the page is that of vacancy and credit loss. You expect to lose two months' rent while you're getting the house ready, but you've made no provision for any future loss.

You decide to assume that a tenant who rents an entire house is likely to be less transient than someone who rents an apartment. Still, it's also reasonable to estimate that you'll have at least one turnover in five years and be at risk for some vacancy at that time. Let's modify the APOD to estimate the loss of one month's rent in the fourth year.

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INCOME					
Gross Scheduled Rent Income	14,400	14,832	15,277	15,735	16,207
TOTAL GROSS INCOME	14,400	14,832	15,277	15,735	16,207
VACANCY & CREDIT ALLOWANCE	2,400	0	0	1,311	0
GROSS OPERATING INCOME	12,000	14,832	15,277	14,424	16,207
EXPENSES					
Insurance (fire and liability)	900	945	992	1,042	1,094
Lawn/Snow	415	436	458	481	505
Repairs and Maintenance	1,800	600	618	637	656
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Real Estate	2,300	2,392	2,488	2,588	2,692
TOTAL EXPENSES	5,415	4,373	4,556	4,748	4,947
NET OPERATING INCOME	6,585	10,459	10,721	9,676	11,260

Your next step should be to estimate the property's taxable income or loss.

This is an excerpt only of Chapter 38, which continues with a detailed discussion of this property.