1

WHY INVESTING IN REAL ESTATE PROVIDES YOU THE BEST ROUTE TO A PROSPEROUS FUTURE

COPYRIGHTED MATERIAL
http://www.pbookshop.com

"Older workers rush back into the jobs market as downturn wrecks their retirement portfolios," so headlined a recent front-page article in the *Financial Times* (May 9, 2009). Other major newspapers such as the *Wall Street Journal*, the *New York Times*, and *Investor's Business Daily* have run similarly disconcerting articles.

The *Financial Times* article (and others similarly written) depart from the mainstream media view that dominates. For the past 15 years, most major media—and especially personal finance magazines such as *Money, Smart Money,* and *Kiplinger's*—have primarily served up inept mantras for the masses disguised as financial wisdom. Such widely read magazines and newspapers have published hundreds (quite likely thousands) of articles that promise investors that they can achieve wealth without work, effort, or thought.

Just keep pouring monthly payments into your IRAs, 403(b)s, and 401(k)s and you will enjoy financial security. "Over the long run stocks outperform all other investments. Over the long run stocks will protect you against inflation."

Indeed, just as I was about to write this chapter, voilá, my local paper obliged with a perfect example. A reader, Nasir Iqbal, posted this comment: "I don't trust stocks. I think I will receive higher returns with property. With property, I will feel financially secure when I retire."

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

The journalist, Cleofe Maceda, responded as follows:

> Is buying property the right way to secure your retirement? Experts [sic] say people like Iqbal are better off looking into other avenues for capital growth—which can reduce the long-term risk of running out of income in retirement.

Maceda (the journalist writing the article) then quotes one of his so-called experts,

> The challenge with property is that you can only sell it for what people are willing to pay. [Duh?] It can take two years or longer to sell a property. There is no liquidity with property.

Continuing a bit further in this article, the journalist again quotes his expert.

> Stock markets offer the best possibility to beat inflation over periods of five years or more. This is because shares produce dividend income in addition to the ability to grow in price.

As to volatility—that other big issue that confronts investors—the mantra persists. No need to worry about 30 to 50 percent drops in the stock markets. . .

> . . . that volatility can work for an investor's advantage because it allows them to maximize their buying power [i.e., when stock prices fall, your $1,000 a month deposits (or whatever) buy more shares].

http://www.pbookshop.com

In one short article, Maceda scores six out of six widely popularized, yet false claims:

1. Stocks outperform all other assets.
2. Liquidity favors stocks.
3. Stocks pay you good income.
4. Stocks protect you against inflation.
5. Stocks reduce the risk of running out of money in retirement.
6. You don't really lose when your stock portfolio crashes, you gain.

Evidently, Maceda—like a majority of journalists (and investors)—prefers not to think for himself. He prefers not to look at the actual

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

historical record of stocks. He prefers to remain ignorant of property. Standing against conventional wisdom, the *Financial Times* (at least in the article quoted) has captured the sad reality of stocks. Maceda only perpetuates the mantra manufactured by Wall Street.

This chapter sets the record straight. It provides you (and Nasir Iqbal) a more enlightened perspective on property, stocks, and several other asset classes (bonds, annuities) that investors might turn to as they strive to build wealth and achieve financial security.

22 SOURCES OF RETURNS FROM INVESTMENT PROPERTY

When so-called experts compare property with stocks, they rarely get their comparisons right. More often than not, they assume that property yields only one source of return that counts: potential gains in price. For example, in his acclaimed book, *Winning the Loser's Game*, Charles Ellis concludes that:

> Owning residential real estate is not a great investment. Over the past 20 years, home prices have risen less than the consumer price index and have returned less than Treasury bills.

http://www.pbookshop.com

Leaving aside for a moment how and where Ellis came up with his long-term house price figures—no statistics I have ever seen report that housing, relative to incomes or consumer prices, has become cheaper—Ellis (and other finance/economics types) err most egregiously in how investors should measure the total potential returns that property offers. Ellis omits at least 20 other sources of financial returns that investors can earn from their portfolio of properties.[1]

To evaluate property, certainly weigh the possibilities for price gains, but go further. You can earn double-digit rates of return (and sometimes much more) from your property investments—even without any gain in price.

It's up to you to decide which sources of returns best fit your investment goals—and correspondingly, for each property you evaluate, which sources of return seem doable. Few properties present a full range of possibilities. But to fully see potential, apply each test of possibility

[1] His two-decade time horizon also fails as a representative period because it includes the late 1970s and the 1980s—treasuries paid record-high interest rates during those years.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

to all properties you consider. Every property presents multiple sources of returns.

Will the Property Experience Price Gains from Appreciation?

In everyday speech, most people do not differentiate price gains that result from appreciation and those that result from inflation. Appreciation occurs when demand grows faster than supply for a specific type of property and/or location. Inflation tends to push prices up—even if demand and supply remain in balance.

Homes in Central London, San Francisco's Pacific Heights, and Brooklyn's Williamsburg neighborhood have experienced extraordinarily high rates of appreciation during the past 15 to 20 years. And just since 1990, houses within a mile or so of the University of Florida campus have tripled in market price—primarily because UF students and faculty alike now strongly prefer "walk or bike to campus" locations.

Areas Differ in their Rate of Appreciation. Although properties located in Pacific Heights and Williamsburg have jumped in value at rates much greater than the rise in the Consumer Price Index (CPI), some neighborhoods in Detroit have suffered major declines in value. Appreciation does not occur randomly. You can forecast appreciation potential using the right place, right time, right price methodology discussed in Chapter 15.

Likewise, you need not get caught in the severe and long-term downdrafts that plague cities and neighborhoods that lose their economic base of jobs. Just as various socioeconomic factors point to right time, right place, right price, similar indicators can signal wrong place, wrong time, wrong price.

You Do Not Need Appreciation. Should you always invest in properties that are located in areas poised for above-average appreciation? Not necessarily. Throughout the rest of this chapter, I show you many ways to profit with property. Some investors own rental properties in deteriorating areas—yet still have built up multimillion-dollar net worths. My first properties did not gain much from price increases (appreciation or inflation)—but they consistently cash flowed like a slot machine payoff.

If you choose a fast money, flip and fix strategy, appreciation doesn't count for much either. Also, when you buy at a price 10 to 30 percent below market value, you earn instant appreciation that is not related to market temperature. Throw away the urge to believe that you can't make good money with property unless its market price appreciates.

http://www.pbookshop.com

Will You Gain Price Increases from Inflation?

In his book, *Irrational Exuberance*, the oft-quoted Yale economist, Robert Shiller, concludes that houses perform poorly as investments. According to his reckoning, since 1948, the real (inflation-adjusted) price growth in housing has averaged around 1—at best 2—percent a year.

"Even if this $16,000 house sold in 2004," says the eminent professor, "at a price of $360,000, it still does not imply great returns on this investment . . . a *real* (i.e., inflation-adjusted) annual rate of increase of a little under 2 percent a year."

Shiller Thinks Like an Economist, Not an Investor. Every investor wants to protect his wealth from the corrosive power of unexpected inflation. Even if we accept Shiller's numbers—and I believe them reasonable, though certainly not beyond critique—the data do show that property has kept investors ahead of inflation in every decade throughout the past 75 years.

Not true for stocks (or bonds). Consider the most inflationary period in U.S. history: 1966–1982. In 1966, the median price of a house equaled $25,000; the Dow Jones Index hit 1,000. During the next 18 years the CPI jumped from 100 to 300. In 1982, the median price of a house had risen to $72,000; the DJIA closed the year at 780—below its *nominal* level of 18 years earlier.

Inflation Risk: Property Protects Better than Stocks. No one knows what the future holds. Will the CPI once again start climbing at a steeper pace? At the runaway rate the U.S. government prints money and floats new debt, the odds point in that direction. During periods of accelerating inflation, most people would rejoice at just staying even.

Imagine that in the early to mid-1960s you were a true blue "stocks for retirement" kind of investor—and you were then age 45. In 1982, as you approach age 65, your inflation-adjusted net worth sits at maybe 30 percent of the amount you had hoped and planned for. What do you do? Stay on the job another 10 years? Sell the homestead and downsize? Borrow money from a wealthy friend who invested in real estate?

Property Investors Do Not Buy Indexes and Averages. Economists calculate in the netherland of aggregates and averages. Investors buy specific properties according to their personal investment objectives. An economist's average does not capture the actual price gains (inflation plus appreciation) that real investors earn.

No investor who intelligently chooses properties for their wealth-building potential selects such properties randomly. Investors apply some variant of right time, right place, right price methodologies (see page 285). If you want to outperform the average price increases of real

http://www.pbookshop.com

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

estate—even though the averages themselves look quite good—you certainly can.

Earn Good Returns from Cash Flows

Unlike the overwhelming majority stocks, income property typically yields (unleveraged) cash flows of 5 to 12 percent.[2] If you own a $1,000,000 property free and clear of financing, you can pocket $50,000 to $120,000 a year. If you owned a $1,000,000 portfolio of stocks, you might pocket cash flows (dividend payments) of $15,000 to $30,000 a year.

Historically, the largest source of return for unleveraged properties has come from cash flow. If you want to grow a passive, inflation-protected stream of income, own income properties.

Economists and financial planners greatly embarrass themselves when they sleight or ignore this critical source of return. Before Charles Ellis, Robert Shiller, and others of their ilk again take up their pens to write on real estate, they might set aside their misguided claims of expertise on realty returns and first learn something about the actual practice of investing in real estate. If they did, they would also learn that nearly all property investors magnify their returns with leverage.

http://www.pbookshop.com

Magnify Your Price Gains with Leverage

Know-nothing economists, financial analysts, and various media-anointed experts claim that price gains from property provide real (inflation-adjusted) returns of one to two percent a year. In doing so, they omit the return-boosting power of OPM (other people's money—typically, mortgage financing).

Low Rates of Price Gain Create Big Returns. Assume you acquire a $100,000 property. You borrow $80,000 and place $20,000 down. During the following five years, the CPI advances by 50 percent. Your property, though, lagged the CPI. Its price only increased by 25 percent. Your real wealth fell, right? No, it increased.

You now own a property worth $125,000, but your equity wealth—your original $20,000 cash equity in the property—has grown to $45,000 (not counting mortgage amortization of principal). You have more than doubled your money. To have stayed even with the CPI, your equity only needed to grow to $30,000.

---

[2] Yields in the U.K., Asia, and most of Europe often fall somewhat below those available throughout the United States.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

Acorns into Oak Trees. Real estate investing builds wealth because it grows acorns (small down payments) into free and clear properties worth many multiples of the *original* amount of invested cash. Let's go back to that Shiller example.

The homebuyer paid a price of $16,000 in 1948. Did that homebuyer pay cash? Not likely. Ten to 20 percent down set the norm—say, 20 percent or $3,600 (.2 × $16,000). At Shiller's hypothetical 2004 value of $360,000, the homebuyer multiplied his original investment 100 times over. Even if we say the 2004 property value comes in at $180,000—the homeowner enjoyed a 50-fold increase of his $3,600 down payment.

What about stock gains during that period of 1948 to 2004? In 1948 the DJIA hovered around 200 (by the way, still about 40 percent below its 1929 peak of 360). In 2004, the DJIA stood at about 8,000—a 40-fold gain. Not bad, but still less than the gains from property (and much, much less when we bring cash flows into the comparison of returns). [Note: As I write in mid-2009, the DJIA still sits around 8,000—whereas property prices (in all but the most distressed areas) are still up from 2004 and way up from 1998, which is the year that the DJIA first hit 8,000.]

Magnify Returns from Cash Flows with Leverage

Traditionally, investors not only magnify their equity gains from leverage, they also magnify their rates of return from cash flows. You pay $1,000,000 cash for an apartment building that yields a net income (after all operating expenses) of 7.5 percent (no financing). Not bad. But if you finance $800,000 of that $1,000,000 purchase price at, say, 30 years, 5.75 percent interest, you invest just $200,000 in cash. Your net income equals $75,000 (.075 × 1,000,000) and your annual mortgage payments (debt service) will total around $56,000. You pocket $19,000 ($75,000 less $56,000). You've boosted your cash flow return (called cash on cash) from 7.5 percent to 9.5 percent (19,000 ÷ 200,000).

Build Wealth through Amortization

Assume for a moment that your $1,000,000 apartment building throws off zero cash flows. You apply every dollar of net operating income to paying down your mortgage balance of $800,000. After 20 years, you own the property free and clear. This property experienced no gain in price. It's still worth $1,000,000.

No price gains from inflation, no price gains from appreciation, and no money pocketed from cash flows. Quite unrealistic and pessimistic, right? Yet, over a 20-year period, you grew your equity from $200,000 to

http://www.pbookshop.com

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

$1,000,000—a five-fold gain, and annual compound growth rate of more than 8 percent.

Your tenants just bought you a $1,000,000 property. That's why I tell my students, "Rent or buy?" asks the wrong question. All tenants buy—the real question is one of ownership. If you rent, you still pay your landlord's mortgage. Your landlord reaps the rewards of ownership—while tenants bear the cost. Seems to me a great deal for property investors.

Over Time, Returns from Rents Go Up

Most property owners raise their rents. Maybe not this year. Maybe not next year. But over a period of five years or more, increasing rents yields increasing cash flows. If you've selected a right time, right place, right price location, demand will push rents up as more people want to live in the neighborhood where your property is located. Or perhaps, as government floods the economy with paper money, inflationary pressures force rents up. Either way, you gain. In fact, you can gain even if your rent increases fail to match the inflationary jumps in your expenses.

Let's return to our apartment building example. Gross rent collections equal $125,000; net operating income equals $75,000; mortgage payments equal $56,000; your cash flow equals $19,000.

http://www.pbookshop.com

Gross rents	$125,000
Vacancy and expenses	50,000
Net operating income	75,000
Annual mortgage payments	56,000
Cash flow	19,000

First, assume your rents and expenses each increase by 8 percent. Here are the revised amounts:

Gross rents	$135,000
Vacancy and expenses	54,000
Net operating income	81,000
Annual mortgage payments	56,000
Cash flow	25,000

An 8 percent increase in rents and expenses boosts your cash flow by 31 percent:

$$25{,}000 \div 19{,}000 = 1.31$$

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

If expenses had increased by 12 percent and rents stepped up mildly by just 6 percent per annum (p.a.), you would still increase your cash flow:

Gross rents	$132,500
Vacancy and expenses	56,000
Net operating income	76,500
Annual mortgage payments	56,000
Cash flow	20,500

$$20{,}500 \div 19{,}000 = 1.08$$

[Note: You can run multiple scenarios with these numbers and other numbers presented throughout this chapter. No results are guaranteed. Through your own market and entrepreneurial analysis, you will both estimate and create the potential returns for the properties you buy.]

But I do encourage you to realistically envision the return possibilities that property investing offers. Then as you evaluate markets, properties, and the economic outlook for your geographic areas of interest, figure the probabilities. Which sources of return look most promising? Which sources of return seem remote? What risks could upset the applecart?

http://www.pbookshop.com

Refinance to Increase Cash Flows

You increase your cash flows when you increase your rents (or decrease your expenses). You also increase your cash flows when you refinance to lower your annual mortgage payments. Today, a future refinancing at rates lower than those currently available seems somewhat remote.

But who knows? From 1930 until the early 1950s, interest rates on long-term mortgages ranged between 4.0 and 5.0 percent. A refi from a 6.5 percent, 30-year loan into a 4.5 percent, 30-year loan would not only slice your mortgage payments by 20 percent, it would lift your cash flows by an even greater percentage.

In some future time, we might again confront mortgage interest rates of 8 to 10 percent. Under those market conditions, a later refinance at lower interest rates becomes ever more likely.

(Note: Chapter 2 introduces a technique called a wraparound mortgage whereby investors can obtain the benefit of a lower-than-market interest rate through seller financing. Wraparounds give buyers a reduced interest rate and at the same time, from a seller's perspective, the wraparound creates another source of return, cf. p. 34.)

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

Refinance to Pocket Cash

Unless history makes a U-turn, buy a property today and within 10 to 15 years, you can sell it for 50 to 100 percent more than the price you paid. You gain a big pile of cash. But what if you do not want to sell? Can you still get your hands on some of that equity that you have built up? Sure. Just arrange a cash-out refi.

Here's how this possible source of return works. Say after 10 years your $1 million property is now worth $1.5 million. You've paid down your loan balance to $650,000. Your equity has grown from $200,000 to $850,000 ($1.5 million less $650,000). You obtain a new 80 percent loan-to-value ratio (LTV) mortgage of $1.2 million. You pocket $550,000 tax free!

But don't spend that cash. Reinvest it. Buy another income property. Yes, you now owe higher monthly mortgage payments on your first property, and your cash flows from that property will decrease. But with the additional cash flows from your second property, your total cash flows will go up. How's that for having your cake and eating it too?

http://www.pbookshop.com

Buy at a Below-Market Price

When the economists (mis)calculate the returns that property investors receive, they omit the fact that savvy buyers often acquire great properties for less than their market value. Opportunity (grass-is-greener) sellers, don't-wanter sellers, ill-informed sellers, incompetent sellers, unknowledgeable sellers—and most importantly in today's markets—financially distressed sellers all will sell at below-market prices.

And unlike in normal times, the financially stressed and distressed today not only include individual property owners but also the mortgage lenders themselves. Financial institutions now own more than a million foreclosures (called REOs) that they must sell as quickly as they can line up buyers to take these properties off their books.

How do you find and buy these properties for less than they are worth? See Chapters 5, 6, and 7.

Sell at an Above-Market-Value Price

How do you sell a property for more than market value? Find a buyer who is unknowledgeable, incompetent, or pressed by time. Offer seller financing, a wraparound, or perhaps a lease option. Develop your skills of promotion and negotiation (see Chapter 13). Match the unique features and benefits of the property. Sell the property with a below-market-interest-rate assumable (or subject-to) loan.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

Sometimes buyers pay more than market value because they don't know (or do not care) what they're doing. Sometimes they pay more to obtain a much-desired feature or terms of purchase/financing. Whatever their reason, if you wish to exploit this possibility, you've created another source of return.

Create Property Value Through Smarter Management

When you manage your properties and your tenants more intelligently, you increase your rent collections (without necessarily raising your rents); you reduce tenant turnover; you increase prospect conversions; you spend less, yet spend more effectively for maintenance, promotion, and capital replacements. You enjoy peaceful, pleasant, and productive relations with tenants.

Fortunately for you, most owners of investor-size (as opposed to institutional-size) rental properties manage their investments poorly. Why fortunately? Because their mal-management provides opportunities for you. Upon acquiring a property, you can execute a more effective and competitive management strategy to increase the property's cash flows and, simultaneously, lift its market value.

How can you achieve such performance? Rely on Chapter 11 to develop your profit-maximizing management *and* market strategy.

http://www.pbookshop.com

Create Value with a Savvy Market Strategy

Although investors tend to manage their properties poorly, they show even less skill as savvy marketers. Go to the property web site, loopnet.com. Click through to a sample of listings. Look at the listing promotional information provided. Look at the property photographs. Does the agent tell a persuasive story about the property? Does the sales message position that property against the tens of thousands of competing properties that also hunger for attention? Do the photographs of properties reveal a well-cared-for property—a property that invites tenants to call it home?

I will give you the answers. No! No! No! The implication? More opportunities for you to gain competitive advantage. When you combine the management know-how and marketing strategy lessons of Chapters 11 and 13, you earn higher cash flows; you provide a better home for your tenants; and when the time to sell arises, your property will command a higher price.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

Create Value: Improve the Location

A famous cliché in real estate says, "You can change anything about a property except its location." True or false? Absolutely false. As Chapter 8 shows, not only can you improve a location, but doing so also offers one of your most powerful sources of return.

Think for a moment. What does the concept of location include? What makes the location where you live desirable or undesirable? Accessibility, aesthetics, quiet, good public transportation, cleanliness, the people who live in the neighborhood, schools, parks, shopping, nightlife . . . the list could go on and on. What's the best way to improve any or all of these attributes? Community action. Examples abound throughout the United States and throughout the world.

Convert from Unit Rentals to Unit Ownership

Buy wholesale, sell retail. A grocer buys a 48-can box of tomato soup and then sells each can individually along with a retail mark-up. Property investors can execute a similar wholesale-to-retail strategy.

Buy a 48-unit apartment building; then, after completing legal approvals and documentation, sell each apartment individually. In principle, you can apply a similar condo-conversion strategy to office buildings, neighborhood strip centers, self-storage warehouse units, mobile home parks, hotels, marinas, boat storage facilities, private aircraft hangars, and other types of rental real estate where potential users might prefer to own versus rent. In each case, you typically pay less per unit (or per square foot) for an entire building than retail buyers are willing to pay for the smaller quantities of space that they require to meet their needs.

Opportunities for conversion profits never remain constant. As property markets change, potential profit margins swing between "make an easy million" to "call the bankruptcy lawyer."[3]

To capitalize on this source of return, monitor the relative per-unit prices of properties sold as rentals (income property investments) and comparable space sold in smaller sizes to end users (see pp. 172–175).

Convert from Lower-Value Use to Higher-Value Use

Assume that in your city, single-family residential (SFR) space rents for, say, $2 per square foot (psf) (due to a severe shortage)—offices rent for

[3] In such distressed market conditions, you might profit from reverse conversions. Buy a fractured condo and operate it as a rental property.

http://www.pbookshop.com

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

$1 psf (due to excess supply). Five years from now, single-family space rents for $1.50 psf (due to excessive overbuilding), and because of strong economic and job growth, office space rents for $3.00 psf. What might you do (if zoning permits)? Convert your SFR to offices.

Conversions of use typically require you to renovate (at least to some degree) the old, lower-value space use to fit the market needs of the higher-value use. But when relative prices and/or rent levels grow progressively wider, conversion of use can generate a lucrative source of returns (see p. 175).

Subdivide Your Bundle of Property Rights

When you own a freehold estate in property, you actually own an extensive bundle of divisible property rights. Such rights may include (but are not limited to):

- Air
- Mineral
- Oil and gas
- Coal
- Access
- Subsurface
- Development
- Water
- Leasehold
- Grazing
- Timber
- Solar/sunlight
- Easement

http://www.pbookshop.com

When Donald Trump built his United Nations World Tower, several nearby property owners pocketed several million dollars. Why? Because Trump paid these owners to transfer a portion of their air rights to him. After purchasing their air rights, the City of New York permitted Trump to build 80 stories instead of 40 stories, as the zoning law then specified.

When you are in Hong Kong, notice that high-rise apartments tower directly above some of the MTR stations. Developers paid the Hong Kong government for the right to use that airspace—even though the government retained ownership and use rights of the land beneath the apartment buildings.

Nearly everyone understands that property owners can sell leasehold rights to earn revenues. (Not all governments, though, permit leaseholds

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

for all properties—and when they do, they may severely limit the terms and price of the leasehold agreement.) However, in addition to leasehold, you might sell, lease, or license other rights that derive from a freehold estate. Transferring one or more of these other rights can generate another source of return.

Subdivide the Physical Property (Space)

In one sense, condominium conversions represent one form of subdividing. But usually subdividing refers to selling or leasing land or buildings in smaller parcels, most commonly, a developer who buys 500 acres and cuts it up and sells off half-acre lots to homebuilders. For another example, consider a shut down Kmart store. A still-thriving big box retailer might pay $10 per square foot to let the entire now-vacant building.

Instead, a property entrepreneur could master lease the property and subdivide the interior space into a variety of uses such as childcare, offices, and/or smaller retail merchants. Each small tenant pays a higher ppsf (price per square foot) rental rate than would the Best Buy or Lowe's who might otherwise lease the total building. If the new space users require lower parking ratios than the old Kmart, the entrepreneur might subdivide some of the parking lot area for additional retail/restaurant uses.

Thoughtful entrepreneurs steeped in market knowledge and possibility thinking persistently search for properties to subdivide. In such cases, the sum of the parts exceeds the value when viewed as a whole.

http://www.pbookshop.com

Create Plottage (or Assemblage) Value

You create plottage or assemblage value when you combine smaller parcels into a larger parcel of land or space. Say you discover a perfect site to build a new neighborhood shopping center. Zoning and planners require a minimum of four acres for such a development. The site equals four acres but it is owned by eight different persons in one-half acre lots. Individually, the lots are worth $10,000 apiece—or $80,000 in total.

However, as a four-acre shopping site, the land would sell for $250,000. You now see how to earn a good profit. Persuade each of the current owners to sell you his lot at its current market value (or even at a price that sits somewhat above market value). Perhaps the champion assembler to create plottage value was the Walt Disney Company. Over a period of 10 years, Disney secretly accumulated 25 square miles of Central Florida land at agricultural-valued prices. Once they completed this assemblage, the value of the aggregate site probably exceeded cost by a factor of 20 (or more).

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

Obtain Development/Redevelopment Rights

Return to the four-acre neighborhood shopping center example. You succeed. You acquire all eight lots at a total price of $130,000 (several of those owners did not want to sell—so you sweetened your offer). Can you start building the center? No. You must first secure a long list of government permits and approvals. So, your $250,000 current site value stands independent of a government go-ahead.

With permits in place, the land could command a price of $500,000. You could sell now and take your profit. Or you could stay in the game. Spend $50,000 (or so) for lawyers, soil tests, public hearings, environmental clearance, traffic studies, and whatever else the city powers throw at you. This permit process requires (with luck—and no unanticipated delays) 6 to 12 months. If all goes as planned, you earn another $200,000.

In real estate, government approvals add to the value of any property that is ripe for development, redevelopment, renovation, conversion—or destruction.[4] Obtain those necessary permits and you earn a good-sized return.

http://www.pbookshop.com

Tax Shelter Your Property Income and Capital Gains

To build wealth, protect your income and capital gains from the greedy grasp of government. Fortunately (under current tax law), investing in real estate provides you more opportunity to avoid paying taxes than any other asset class.

Depreciation (noncash) deductions shelter all (or nearly all) of your positive cash flow. A Section 1231 exchange shelters your capital gain as you pyramid your investment properties. The $250,000/$500,000 capital gain exclusion provides you tax-free gains from the sale of your personal residence(s). A cash-out refinance (that your tenants will repay for you) deposits tax-free cash into your bank account. And if you buy a "first-time" home, the newly enacted $8,000 tax credit provides part (or maybe all) of the cash for your down payment.

Some naïve souls might object. "I can build my stock market wealth tax free through my 401(k), 403(b), and IRA plans. That tax break beats property."

Well, even if that tax break did beat property—which it doesn't—you forget that when you begin to draw on that cash during retirement, the

[4] Yes, government even requires permits to tear down buildings. In Sarasota, Florida, the Ritz Carlton fought a four-year battle to obtain permission to tear down a historic house located on part of the site where the Ritz planned to build. In compromise, the Ritz eventually paid to move the house to another site.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

government will tax every penny as ordinary income. In addition, if you want to tap into that cash kitty prior to reaching age 59-1/2 (as nearly 50 percent of Americans do), the IRS will grab 35 to 50 percent of those amounts (taxes plus penalties). If you die before you withdraw, the IRS still reaches in and pulls out its share.

To minimize loss of income and wealth to the IRS, buy investment real estate. (For a discussion of property taxes and income tax laws, see Chapter 14.)

Diversify Away from Financial Assets

Although some investors prefer stocks, those investors would prove themselves wise to diversify part of their portfolio into property.

As investment experience shows, during periods of expected and unexpected inflation, property prices have kept pace with or exceeded the rate of growth in the CPI. Even better, leverage transforms small price gains into double-digit rates of increase in your equity wealth.

Property prices show much less volatility than stock and bond prices. The recent depression, surfeit of foreclosures, and price downturns for many properties seem mild compared to the precipitous periodic drops in stock prices. Even in the hard-times property markets, prices have only fallen back to their 2004-2005 levels. As I write, all major stock indices sit below their levels of 1998.

Today, most financial planners encourage asset diversification. Historical as well as recent experience support that view. The mantra "stocks, stocks, and more stocks for retirement" does not meet the test of experience. Add property to your investments—if not for its superior returns, then to reduce your portfolio risks.

http://www.pbookshop.com

IS PROPERTY ALWAYS BEST?

Some people think that I serve as head cheerleader for investing in real estate. In one sense, they are right. The record shows that more average people have built sizeable amounts of wealth through property than any other type of savings or investment.

However, I do not say, "Property investments will beat stocks or bonds any time, any place, at any price." As early as 2005, I told my investor audiences that I would not buy property in the then-current hot spots such as Las Vegas, Miami, Singapore, Dublin, or Dubai. Speculative frenzy drove those markets—not reasoned fundamental evaluation of risks and rewards.

P1: OTA/XYZ P2: ABC
c01 JWBT174/Eldred August 26, 2009 20:44 Printer Name: Courier Westford, Westford, MA

So, when people ask me, as they often do, "Which investment provides the best returns —stocks or real estate?" I answer, "It all depends."

Certainly, in 1989, I would rather have invested in the S&P 500 index fund than Tokyo real estate. In 1993, I would have preferred the DJIA to property in Berlin. In 1997, I would rather have bought Apple Computer stock than a Hong Kong condominium located on the Peak.

You must rely on investment and market analysis. Investors do not always make more money with property than they do with stocks. I have never said otherwise. But that begs the question, "Which investment offers the best possibilities and probabilities today?"

Given today's bargain property prices relative to where property values will likely stand 6 to 10 years from now; given the fact you can build large increases in property wealth (equity) without big gains in price; given the relative income yields of property versus stocks (or bonds); given the tax advantages of property relative to all other investments; given the multiple sources of returns that property offers; and last—but far from least—given the entrepreneurial talents that you can apply to property to increase its price and cash flows; then, yes, in today's market, I am willing to lead the cheers for investing in real estate.

http://www.pbookshop.com