

BY WESTLAND APARTMENT
INVESTORS, INC.

The Four Engines of Investment Real Estate

With a focused strategy and a little patience you can achieve unusually high returns.

How apartments make you money

As a homeowner you are aware of your home's increase in value over time due to appreciation. Additionally, the mortgage balance gets paid down and you receive tax benefits by deducting the mortgage interest paid each year. Apartment dwellings give you these same benefits, except the apartment generates income to pay the mortgage, taxes and expenses, and generally gives you income. In addition, they can be depreciated so that you can decrease your personal tax liability when the investment appreciates in value.

Breakdown of the four engines:

- 1. Cash flow** This comes from the rental business that is housed within the property. It is the monthly/yearly profit after income is collected and all the bills are paid, including the mortgage and real estate taxes.
- 2. The mortgage is paid down each month** As part of the operating expense of the property the residents pay this, not the investor/owner of the property.
- 3. Depreciation of the buildings and personal property** Each year depreciation creates an accounting expense which, when added to the other expenses of operation, can create an operating loss called a "paper loss". This happens despite the fact that most properties increase in value year after year. When the depreciation is added to the total expenses of operation and the mortgage payments, it generally causes total expenses to be greater than income. When expenses are greater than income, the loss can be used as a deduction on your personal income tax, which lowers your personal income tax each year. The net effect of this reduction is spendable income you could not enjoy without your apartment investment. The amount of personal income that you get will be different for each investor because it is based on your personal income. The greater your personal income tax liability, the more valuable the benefit of ownership becomes to you.
- 4. Appreciation of the market value.** The property can appreciate each year due to any number of factors. Foremost among them is inflation caused by increased demand for certain types of real estate or locations, increases in the income due to better apartment management, or a physical up-grade of the apartments or neighborhood. Of the four ways to make money with apartments, appreciation is by far the most lucrative, particularly when coupled with leverage. It is also the least predictable or measurable in the beginning of the investment period.

Leverage

Leverage is what makes appreciation work so impressively.

For example, in the stock market, if you invest \$100,000, and the value of the stock goes up 3% the first year, you made \$3,000 on your investment that year. However an investment in apartments is usually purchased using a down payment and mortgage, which is then paid using the proceeds from the apartment operation. In other words, the investment is made with leverage. Currently, the majority of mortgages are 75% of the value of the property with a 25% down payment. If the same \$100,000 used in the stock purchase example is invested in property using a 75% mortgage, you have purchased a \$400,000 asset. Using the same 3% annual appreciation in value on a \$400,000 asset, the value went up \$12,000 each year. That \$12,000 represents a 12.5% return on your \$100,000 investment. It's important to remember that leverage can be over done and lead to problems. Like most things in life, a prudent balance is best.

The capital gains tax deferred benefit – 1031 exchanges

An additional and significant benefit of owning investment real estate is that the IRS allows an investor to sell and then defer the capital gains tax, if the transition is made by following IRS rules for a 1031 tax deferred exchange. Currently, most movement from one investment property to another is done this way. If your tax on the sale is deferred, the amount you have to reinvest in real estate is greater than it would be if you had to pay the tax. So you are then getting a return on the money you deferred paying in taxes. The IRS will not let you do that with other investments. When you sell stocks or bonds for instance, and move the money to a new investment, you pay the capital gains tax on the sale before you reinvest.

Why isn't everyone doing it?

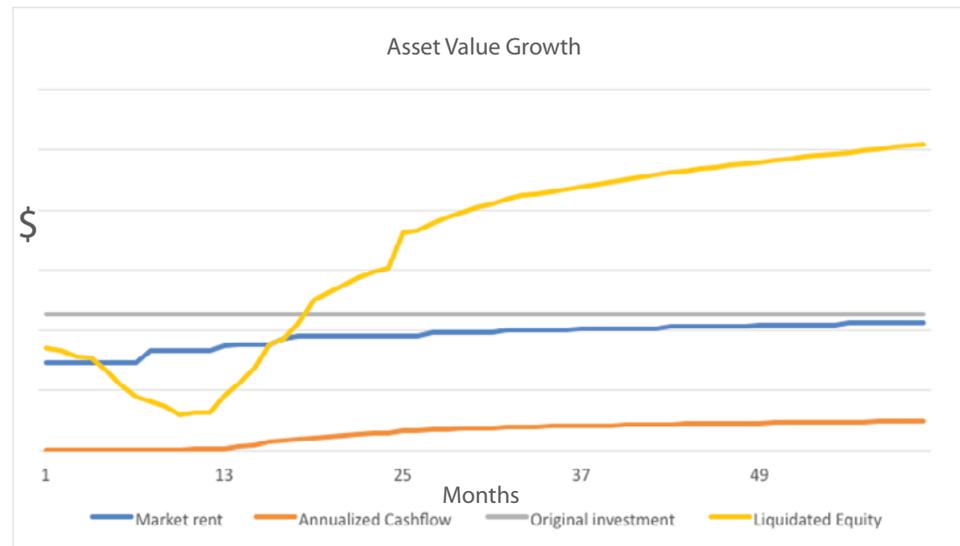
You might wonder "if the various returns on real estate investments are so great why isn't everyone doing it?" Some of the reasons are: the buy-in is higher than many investment alternatives, the investment property needs to be regularly managed, and the investment is not as easy to move in and out of as some other alternatives.

Patient execution of strategy yields higher returns

Often the plan for a newly acquired property is to make investments over the first year or two to bring the property up to the level of functionality and visual appeal that improves the property's standing in the local community and justifies higher rents. This is the plan for the typical Westland apartment investment. The upgrades to the property enhance its value independently of conditions in the general real estate market, and provide a degree of insulation against market softness. But the upgrades cost money and take time, typically resulting in a dip in net investment value and a delay in investor cashflow during the upgrade period.

The following chart shows the typical story. The vertical axis is dollars and the horizontal axis is time. The market rents increase quickly during the upgrade

investment period, and when the upgrades are done, the net equity in the property is much higher than it would have been if no improvements were made.



Worth the wait

People who can't wait for larger returns later in time may not be good candidates for getting involved in multi-family real estate.

There are benefits to not having more people drawn to investment real estate, however. If the number of buyers over balance the supply of opportunities to such a degree that the cost of the income stream (cash flow) is bid up, then the price of the investment is higher, as we have seen in the stock market. Another benefit with real estate investments is that you are betting on the real estate, a unique and known quantity that isn't going away and cannot be exactly replicated. With stocks and many other investments you are betting on people or a business that can disappear tomorrow.

Management is key

The key element that leads to the successful appreciation of any apartment investment is the management of the daily operation. The market value of the property is mostly based on its ability to generate income. Most any investment can be made to look good on paper in the beginning by understating operating expenses. People who manage apartments on a regular basis live with the realities of the operation cost and what can be done to improve the current income. They will be hard to fudge, especially if they are expected to manage the property after the sale. A management team has to steer the daily operations of the business after the purchase in order for the investor to get the anticipated return. Professional property management efforts and talent should not be taken lightly or for granted and should be evaluated and monitored.

Smaller properties (houses and plexes, generally) need to be managed by an owner because not enough income is generated to afford a good on-site manager and regular professional management. That is why it is not uncommon for smaller investors to become part of a partnership so a larger property can be purchased. Good professional management can then come in and allow owners to have a more passive relationship with their investment and still get the benefit of owning apartments. Most owners prefer a monthly operating report rather than telephone calls from tenants at their property.

All of these are great reasons to invest in an apartment building and are also reasons why many don't.

Conclusion

Finding and purchasing a desirable building for a good price, leveraging your investment, and managing it with the proper resources, by executing each of these steps apartments can be a great investment and bring a consistent return on your money.



Westland Apartment Investors

1600 SW Cedar Hills Blvd
Suite 101 B
Portland OR 97225

Phone: 503.297.2575
Fax: 503.297.2576

Email:
contact@westlandinvestors.com
Website:
www.westlandinvestors.com