Income and Appreciation in Real Estate Investing

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There are three reasons to invest in income producing real estate: Income; Appreciation; and Tax Benefits. Let's examine the areas of income (positive cash flow) and appreciation (property increasing in fair market value) and how different real estate markets may give investors a better return for their investments.

An important study was done regarding income producing property in the San Francisco Bay Area. The study found that net income (positive cash flow) was between 2% and 2.9% of cash return based on cash invested in income producing properties in the Bay Area. This study found that if you own a multiple tenant income producing property in the Bay Area your average rate of return based on the amount of money you have paid into the property would only be between 2% and 2.9%. In other words, you buy a six unit apartment building for $1,200,000. You put 25% down ($300,000) and will receive rents of $7,200 per month (a total of $86,400 for the year). But, you will have expenses including mortgage payments, property taxes, insurance, management, utilities, repairs, etc., that will be $6,575 per month (a total of $78,900 for a full year). That means that your net positive cash flow is projected at $7,500 for a full year and remains at this amount or even goes lower unless you are able to raise the rents.

This positive yearly cash flow of $7,500 means that your IRR (internal rate of return based on the amount of money you have invested) will be 2.5% ($7,500 is 2.5% of $300,000). While 2.5% is currently better than putting your money in the bank (getting a CD or money market account), it is pretty low compared to just doing passive investments such as bonds or dividend paying stocks. Why then do some many investors want to buy real estate in the San Francisco Bay Area? The answer is simple. In the past few years Bay Area real estate (including apartment buildings) has greatly appreciated in value. In fact, Bay Area real estate has a history has a history of years of high appreciation and then years of going down in value (remember 1991 through 1996). This volatility attracts many real estate speculators who can either make a lot of money based on high appreciation, or can lose money based on timing the market incorrectly.

It seems that most investors (e.g. the stock market) follow the trends and buy at the wrong time. Now is actually the time to sell real estate in the Bay Area (take profits) and invest your money in areas of the country that have less volatility, much more room for appreciation, and can give an investor a much better cash-on-cash (IRR) return on their investment. For example, in cities like Phoenix, Dallas, Jacksonville, you can buy large multiple unit apartment complexes and receive a cash-on-cash return of 9% to 14%. That allows much more safety and flexibility on your real estate investment, while the property can appreciate at a more gradual pace over time.

The ideal situation would be buying various properties (including new single family homes) in various good economic, high growth, Sunbelt cities that allow you to diversify your investment and lower risk. The problem, of course, is money! Individual investors, no matter how wealthy, will quickly run out of cash to buy the right mix of properties in the right areas. Therefore, a real estate investment fund having experienced directors with a network of local real estate brokers, property managers, and mortgage lenders may make sense.

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