EXECUTIVE LEGAL & ACCOUNTING GUIDE

REAL ESTATE

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Repositioning your real estate – Is it time to turn on the cash?

We live in perhaps the most desirable place on the planet. And yes, many of us living in the North Bay have had the tremendous foresight – all right, we got lucky – to buy local real estate years ago. For some, it's our principal residence, but for others, it's multiple single-family residences, or SFRs, and other types of investment properties as well. The great news is that our North Bay real estate, especially SFRs, bought at least five years ago have enjoyed substantial appreciation. As I reflect on our firms' many client stories over the years, my informal survey suggests that their local real estate investments have contributed as much or more to increase family net worth than any other asset category. Patient real estate investing is very strongly correlated with long-term financial success. Given this reality, we really must be more disciplined in critically reviewing and, when appropriate, repositioning our real estate investments – as we do with our financial portfolios.

Our real estate assets generally occupy a significant portion of our family worth. The powerful benefits of leverage in our appreciating market have yielded phenomenal results. Local real estate equity escalation has outstripped investment returns in other asset categories. A simple example to illustrate the point: Mr. Novato purchased his SFR nearly ten years ago for $500,000. With an average annual appreciation rate of 9%, today it is worth $1.2 million. But he did not buy the home "all-cash," unlike stock and bond investments. He obtained 80% financing, or $400,000, requiring a $100,000 down payment. So Mr. Novato has controlled a $500,000 appreciating asset with only $100,000 of his own money – five to one leverage – and watched it grow in value to $1.2 million in a 10-year period. For simplicity sake, let's assume an interest-only loan, break-even cash flow, and $75,000 in transaction costs. Mr. Novato has turned $100,000 into $725,000 – $1.2 M less $400K loan less $75K closing costs – in a mere 10 years. He has made his investment back six plus times and achieved an annual rate of return of roughly 22%! And remember his 22% return was achieved in "only" a 9% rising tide real estate market.

Many of you already understand the benefits of leverage in a rising market. However, too many of us are failing to reposition our real estate portfolio to better meet our current financial objectives. I challenge you to answer the following questions with respect to your real estate holdings, excluding your personal residence, and then I'll explain how you can dramatically improve cash flow:

1. What is the gross value of my real estate holdings?
2. What is my total debt amount secured against this real estate?
3. The answers to the above two questions will provide you your real estate net equity – subtract #2 total from #1.
4. What is your typical annual cash flow from this real estate?
5. Take the answer to #4 and divide by #3 to determine your current cash-on-equity return for your real estate portfolio.

If you own multiple SFRs in the North Bay, then my prediction for your answer to #5 above – your annual cash-on-equity return – is probably less than 2%. Perhaps it is even a negative cash return! This is the dark side to our local real estate market; although property values have appreciated substantially, the rental market has not even remotely kept pace with this increase in value. If we have not yet re-positioned our real estate holdings, what we now own is an asset class that has done quite well for us over time, but that today produces very, very little cash return in comparison to its value.

Allow me to illustrate this point with real numbers. Ms. Napa currently owns five SFRs with average values and debt of $600,000 and $250,000, respectively. The cash flow per property is barely positive – about $25 per month. Let's now apply the analysis we set forth above:

1. Total Value = $ 3,000,000
2. Total Debt = $ 1,250,000
3. Net Equity = $ 1,750,000
4. Annual Cash Flow = $ 1,500 ($25/month x 12 months x 5 properties = $1,500)
5. Cash-on-equity return = < 1/10th of 1% ($1,500 cash flow / $1,750,000 equity)

Ms. Napa is therefore employing $1,750,000 of capital to generate a meager $1,500 per year. Now this might be just fine if she is not interested in maximizing cash flow, feels her properties will continue to appreciate at a high rate and doesn't mind continuing to actively manage her rentals and deal with tenant issues, vacancies, repairs, etc.

However, if she is interested in producing more cash flow, she could instead reposition her portfolio and turn the $1,500 into more than $100,000 per year. That's worth repeating – Ms. Napa can turn her current insignificant cash flow into more than $100,000 per year! This represents only a 5.7% cash return on $1,750,000 of equity and is easily achievable, even after sales transaction costs, if she converts her SFRs into other types of real estate investments – multi-unit residential, shopping centers, office buildings, industrial space, mobile home parks, etc. This is particularly so in many parts of the country as contrasted with the low-capitalization rates and cash-on-equity yields in our North Bay SFR markets.

But realistically, how can Ms. Napa locate, evaluate, buy and manage these other types of properties located in other parts of the country? She can do so by buying partial interests in tenant-in-common properties offered nationwide through the burgeoning syndicated TIC industry. Many TIC interests are managed by nationally recognized property management firms, and many of the properties that are offered are of Class A type that would not otherwise be made available to private investors other than through a TIC offering. This allows Ms. Napa the ability to break her real estate equity into smaller pieces and purchase a greater number of properties of differing types and in different areas.

Besides dramatically improving her cash flow, Ms. Napa will have achieved diversification of her holdings, better protecting against risk of loss. For example, how exposed is her current net worth to one truly significant Northern California earthquake? Wouldn't it be better to not have 100% of her real estate worth exposed to this type of catastrophic risk?

By diversifying her real estate equity through purchase of TIC interests, Ms. Napa will also enjoy much greater free time. Since her new properties will be professionally managed, she will no longer need to be directly involved with tenant matters, vacancies, repairs, phone calls, etc. Besides her quantity of money, her quality of life should take an "up tick."

And there is no catch. She can accomplish the repositioning of her portfolio and achieve the benefits described above – greater cash flow, greater protection, and greater free time – without paying $1 in income tax. One of the principal reasons that TIC offerings have gained so much in popularity is that, if properly structured, they qualify as IRC Section 1031 tax-deferred exchange property, unlike partnership or LLC interests.

There are numerous other advantages offered by purchasing the right TIC investments, but there are some trade offs and some dangers to be wary of as well. So like any other important investment decision, you need to employ the services of a qualified professional to assist you in these purchase decisions.

Is there room for improvement in your real estate portfolio? Are you working for it or is it working for you?

About The Author

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Steve Ghirardo is both a CPA and Real Estate Broker. He and his brother Jerry are the Principals of Ghirardo CPA (full service accounting and tax firm), Ghirardo Real Estate Group (real estate investments, brokerage and consulting) and Exchange Alliance Group (a Section 1031 Exchange Accommodator).

Steve has provided real estate consulting services from a CPA's perspective for over 20 years. The Ghirardo Real Estate Group consists of CPAs and licensed real estate and securities professionals who assist clients in all aspects of real estate investing, including: real estate portfolio evaluations, locating suitable 1031 replacement properties, evaluating and screening TIC offerings for purchase, feasibility analysis, income tax and property tax analysis, financing and sales.

Steve received a BA in History from Stanford University in 1980 and an MBA from UC Berkeley in 1982. The American Institute of CPAs recognized him for performance with high distinction for placing within the top 120 scores in the country of the 70,000 individuals taking the CPA exam in November of 1982. In 1992, Steve earned a Masters in Taxation from Golden Gate University in San Francisco, receiving the "Outstanding Graduate Award." Steve currently sits on the Board of Directors for Circle Bank and has been the Novato Rotary Endowment Treasurer since 2002.

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