

10 Important Factors Before You Buy by Craig A. Lane, C.C.I.M.

Too often, people buy property based on what they have been taught to see on the bottom line of a piece of paper. The analysis of real estate investments can take any number of forms, but no matter which approach you use for the property being invested, you should be sure to first address the important considerations that follow.

Checklist of Factors

The best way to develop a clear picture of the property and its potential is to examine all of the principal factors and then integrate them into a meaningful conclusion.

1. LOCATION: This, of course, is one of the most important factors of all. The desirability of a particular location is a constantly changing factor and a judgment as to the present quality of a certain piece of property can be seen as part of an evolutionary pattern. For example, consider the following:

- A) A fully developed residential neighborhood has reached a plateau is likely to improve slightly
- B) A moderate-income residential neighborhood is more likely to improve than to decline
- C) A strong retail or office district is likely to continue to improve unless it is challenged by a stronger district.

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2. IMPROVEMENTS: An improvement should be judged by other structures of its own type in relation to its location and by its rental structure. Certain types of improvements, such as hotels, motels, bowling alleys and restaurants are not really improvements of real estate but parts of business enterprises. When you buy such a property, you are in effect buying real estate plus a business. In many cases, if the business does not work out, the existing structures cannot be used for other purposes and must be demolished if the property is to be put to some other useful purpose.

3. RENTAL SCHEDULE: The questions that should be considered here are: a) how competitive is the rental level; b) where is it headed and c) what is a stabilized level? One mistake in this area is to automatically assume that the rental level is equal to the rental value. This is not always the case. The present rental level merely indicates what the present tenant is willing to pay for the premises. Premises rented at a bargain price in a good community have greater rental value than a high-paying space in a declining area. Also, a poor apartment in a fashionable neighborhood will bring more than a much better unit in a middle income area.

4. EXPENSE: Here you have to estimate what problems will develop during your ownership. Actual expenses incurred by the Seller may be less reliable than an informed estimate, since there is usually a wide variance from year to year in such annual expenses such as maintenance, insurance and renting. Using a percentage-of-income formula is also not all that reliable. As a building ages, rents are likely to increase, while income is likely to decline. Our best guide is an educated estimate of the future expenses based on the information that is available.

5. NET INCOME: Free and clear income is the best measure of real estate – before a premium or penalty resulting from financing. One area to watch is earning for the owner's services. The time and effort provided by the owner as well as the risk are factors that should be carefully considered when determining a capitalization rate.

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6. FINANCING: When must the mortgage be refinanced? Will replacement be readily available? How will service on the amortized balance compare with current charges? Is it likely that new, increased financing will be available?

7. LEVERAGE: You should know the amount of equity cash that will be required when you acquire the property and in the future. The less cash you invest, the better the leverage and the lower the risk. Spreading your capital over several properties will permit the same dollars to control more real estate.

8. TAX CONSEQUENCES: Low amortization (and higher interest) is great for taxes but not for refinancing. High land values hurt depreciation deductions but give the best opportunity for growth and stability.

9. PRICE: It is a littler better to pay a little more for what you want than to pay a little less for something that does not fit you goals.

10. RISK FACTORS: After years and years of increased value, many metropolitan areas are certain to decline in the next two years. The biggest risks are with properties consisting of two to four units.

The Riskiest Housing Markets

According to the National Association of Realtors, Southern California has three of the top ten riskiest metropolitan markets in the United States. San Diego, Carlsbad and San Marcos are fourth on the list with a 43.3% chance of a decrease in value followed by Los Angeles, Long Beach and Santa Ana which ranked eight on the list with a 35.9% chance of decrease in value. Lastly, Riverside, San Bernardino and Ontario came in ninth on the list with a 31.6% chance of a decrease in value.

CAUTION: Though rental rates may still be increasing in most markets, one needs to look at the risks in lower values. Contrary to the investment rule of thumb, "as income goes up, prices go up", in some markets as stated above, though rents may increase, values could still come down.

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