Investments: Real Estate

How Much Money Did You REALLY Make on Your Real Estate Investment?

By: Joe the Investor

Have you heard this statement before? “I made a lot of money on this property – I bought this house for $200,000 and I sold it for $300,000”. Have you ever been in a conversation with someone and heard a story similar to this? Does $100,000 sound like a good return on investment? It depends on many factors. The example in this article will initially focus on real estate used solely as an investment, but your principle residence will also be examined this way if you are trying to figure how much money you have made living in your house.

How long did it actually take this person to make this money?

If you bought a house for $200,000 and sold it for $300,000 one year later, versus 20 years later, this makes a big difference. Why? When looking at investment returns, you have to look at how long it took for you to achieve the return. This is true because when looking at other investments, time as well as the return itself will be the common yardsticks for comparison. If the price increase of $100,000 happened in one year, this is a 50% return in one year. Other investments might average 1% for cash, 2% for bonds, and 5% for stocks for that same time frame. If you made this $100,000 in 20 years, this would mean 50% spread over 20 years. If you do a simple linear calculation, that is 2.5% each year. Now, the bonds and stocks are pretty attractive compared to this real estate investment. This is important because most people hold on to real estate for a long time and forget how long it took them to achieve the return that they received.

The numbers presented are usually only about the buy and sell price

Did you notice that the only numbers mentioned in this example are the buy and sell prices? For most goods, these are the only prices that matter when examining if you made money or not. With real estate, this is not true. Why? Real estate has to be maintained, which is not the case for stocks, bonds, cash or any other paper based or contract based investment. Why does this matter? If you have ever lived in a house, you know that there are utilities to pay, renovations to make, repairs to perform and taxes to pay. If you were to buy a GIC at a bank, and the bank said to you: “you will receive $100 in interest each month. However, to keep the GIC you need to pay $20 a month for a maintenance fee.” Wouldn’t this mean you would only make $80 per month, and not $100 per month? This same thinking applies to real estate. If you buy a house as an investment, and you have to pay utilities, taxes, renovation costs, mortgage interest, and repairs as well as costs to buy and sell the real estate, shouldn’t these be accounted for in your return? If you are renting the property, the rent collected would also add to your return. If you are trying to rent a property, but it is vacant for 6 months, that 6 month period is not part of your return.

As an example related to the above, let's say the house was bought for $200,000 and sold for $300,000, and it took 5 years for this transaction. To actually buy the house, the legal fees, land transfer taxes, mortgage contract and real estate fees amounted to $1000, $3000, $500 and $5000 respectively. The total set up costs would be $9500 so far, which would be subtracted from the money you made, because it actually costs you $200,000 PLUS $9500 to physically buy the house.

Let's say now that you rented the house for $2000 per month, but you had mortgage costs of $600 per month in interest (note that the principle is not included in this figure because principle is your money that you receive in return). You also have property taxes of $250 per month and utilities of $500 per month. You are netting out $2000 - $250 - $500 per month or $1250 per month. With the mortgage interest deducted from this sum, you would have $1250 - $600 or $650 per month. This equates to $7800 per year in extra income. Since the house was rented for the entire 5 year period – this is an additional $39,000 in return.

If for example, work had to be done to get the house ready to rent, wouldn't this cost be part of the return as well? This is money that you have to spend, and it is only being used on this investment property. If it cost you $5000 for paint, landscaping and minor repairs, this would come off of your investment return.

If the roof had to be fixed during that 5 year period, and you paid another $5000 for that repair, the whole amount would be deducted from your return. People may argue that the roof will last another 25 years, which is true – but you only receive the benefit of these repairs if you keep the house! If you sell the house, you may receive the benefit of keeping the house well maintained in a higher selling price, but it will also depend on how hot the real estate market is, what the local neighbourhood is like and other factors which are beyond your control and will come into play only at the time that you are making the sale. This means now that you have an additional $10,000 deducted from your return.

To sum up so far, the house profit generated was $100,000. You would subtract $9500 in closing costs to buy the house, add $39000 in rental income less expenses, subtract $5000 for minor repairs, and deduct a further $5000 for a major repair. This would leave you with $100,000 - $9500 + $39,000 - $5,000 - $5,000 = $119,500. Since this transaction took 5 years to complete, the $119,500 should be spread over 5 years. This means that the return per year is $119,500/5 years or about $23,900 per year. Since the original price of the house is $200,000, this means that you are making $23,900/$200,000 or about 12% per year. This is a relatively good return, but if stocks are making 10% per year, this is fairly comparable to what everyone else is getting. Would you have that impression reading only the original story: "I made a lot of money on this property – I bought this house for $200,000 and I sold it for $300,000"?

What About the Effort in Managing the Real Estate Property?

Consider the time you are spending on your house. If you are a landlord, you will have to inspect your house, make sure your tenants are paying you on time, look for tenants and do minor repairs. If you don't like doing these things, this is considered work and it will cost you in terms of time you could be doing something else. How to account for this? Tabulate how long it takes you to manage the real estate investment, and multiply how many hours you spend by how much money you are making at work – this would represent a substitute for what else you could be doing since you are already working in that job. If you spend 5 hours per month maintaining the house, and you make $20 per hour at your day job, this is an additional $100 per month in costs. This translates into $1200 per year in your time. Note that with paper based investments like stocks and bonds, there may also be time required to read the news, follow how the stock market is doing and research for timing and alternative investments. An underlying factor here is whether managing real estate feels like a job or a hobby. If it feels like a job, the time should be treated like a job. It the time spent is enjoyable and feels like a hobby, you will get benefits that cannot be quantified and it will likely not bother you to spend time taking care of the property.

If you spent time cleaning up the property or moving things left on the property by previous owners, this would all be included in your costs. The rule of thumb is that any money or resources you would have to outlay for this property would be added to the costs and would affect the final return. Any extra money generated, like rent or credits would be added to the return. Another way to say this is: if I didn't own this investment property, would I still be spending this money? If the answer is no, this would be deducted from your return. If the answer is yes, the cost would not be deducted.

What about taxes?

Taxes have been left out of the calculations so far, but if this is an investment property, there will be capital gains taxes on the return generated. They may even be taxes on the rental income if it is deemed to be income, and all of these numbers would get reduced. This is also not part of the story that people describe for their own real estate experience, but you should consider this in your experience. If you borrow money, the interest is tax deductible for an investment property so the situation goes both ways.

What about Leverage?

It was assumed so far that you are buying the house with cash, or you are borrowing money and receiving it in return once the house was sold. There are calculations out there where people put a fraction of the price of the house as a down payment, borrow the rest and then buy and sell real estate. There are expenses similar to what was calculated above, but the base for the return calculation is much smaller, which makes the return much bigger.

Going back to the story in the first paragraph, you do not know if the person borrowed money to buy the house or not. Most people don't consider that as part of an investment return and don't tell you that as part of their result.

Let's say you would put down 10% of the value of the house when you buy it. This would equate to $200,000 x 10% or $20,000. Over the time that you borrow the money, you would be paying interest. Any costs involved in setting up the borrowed funds, like appraisal of the property, legal fees or bank fees would be part of the financing costs. The interest paid would be part of your investment as well. If you borrow $180,000 and the interest rate is 4%, you are paying $7200 per year. Over 5 years, this is $7200 x 5 or $36,000. If the cost to set up the loan was $3000 in total, the actual amount of money that you invested would still be $20,000. The costs to set up the loan and the interest charges would be deducted from the return. Looking at the original example, if you have a gain or $100,000 plus the adjustments, the total gain was $119,500. If you subtract the costs of the leverage, you would have a net gain of $119,500 - $3000 - $36,000 or $80,500. If you were to go ahead and calculate the return on your investment, you would use a base of $20,000, and a gain of $80,500. Since the time period to earn the return was 5 years, this would be $16,100 per year. On this base amount, the return would be 80.5% per year. This number is much larger than what you had without the leverage – the only difference is that the money was borrowed rather than paid in cash. Once the house is sold, the bank would have to be paid the $180,000 that was lent, but you get to keep the whole gain over and above that amount.

Leverage can be good or bad depending on whether you make or lose money. Leverage magnifies your gain and your loss. Since most real estate deals happen with borrowed money, be mindful of how these numbers get calculated. It may be the leverage that makes the return astounding, not the return on the original investment using cash. If you see advertising for real estate return calculations, be mindful of how much of these returns are based on leverage versus the actual gain in the property itself.

What if the Price of the House Goes Down?

Yes, prices of real estate properties can go down. In the long run, prices are said to move up almost always, but this is also true for stocks, bonds, and physical goods as well. The reason why prices go up is not entirely because real estate is a good investment – it is because inflation keeps rising, and as that happens the numbers will always get bigger. If you have a fixed amount of something, and the number of dollars keeps rising, the number of dollars available to buy each thing will get larger. This is why all investments will go up if you wait long enough and if the merits of the investment are still true in the long run. If the price of the real estate property decline while you are holding it, all of the expenses will still be there. This is why some people lose money in real estate. It may take 5 or 10 years for a property to recover in value once it begins to decline – so you have to be willing to wait about this long if you want the adage to be true.

What if I Live in the House?

If you live in the house, the wrinkle in the calculations is that some of the money you are paying is for expenses you would pay anyway. If you didn't buy a house and rented an apartment, you would have to pay some equivalent in rent and bills. You can take the difference between those two situations and this would be the money expended, and the return generated as well. Contrary to what a lot of people say, owning is not always better than renting – it depends on the circumstances and what is important to you. What you choose as a lifestyle is very important when deciding whether you have a house for the money or because you like to live there. There will not be any taxes on a house that you live in compared to an investment property, which is another important consideration.

What if I Have a Business at Home?

If you live and run a business from home, this is even more advantageous to you because you can write off expenses and reduce commuting time and other costs of going to work, while still retaining the income that the work generates. This would generally make the expenses of owning a home cheaper because some of them are tax deducted, and the home make generate more income because it replaces location expenses. The idea of choosing your lifestyle becomes more important here as your home life and your work life are being stationed in one place. If there are issues with your home, this will have a larger effect on you.

Real estate is not a good or bad investment – it can be all of the above. The point of the article is that people misrepresent what actually happens in real estate by leaving out selected information. It is usually losses and monthly expenses that are ignored in favour of the big gain made on the price. All aspects of the investment need to kept together to find out if it is really worth it for you to buy real estate.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what these options are. **Note: This article is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**