Property Management Essentials:

Rental Investment Return and Denver-area Market Analysis

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PROPERTY MANAGEMENT

Key Topics

- ***The Hidden Gem: Principal Paydown***
- ***Tax Deductible Expenses***
- ***Leveraging the Depreciation Expense***
- ***Appreciation Property***
- ***Cash Annuity from Increased Rents***

Echo Summit frequently gets asked "is it time to sell my rental property?" We find that property owners sometimes lose sight of the larger picture of the benefits of rental property ownership... especially in Denver.

In this paper, we examine the benefits of principal pay-down, tax deductibility of expenses, depreciation, appreciation, and the eventuality of a cash annuity. We then explore recent trends and statistics affecting the local rental market. This paper is not intended to be a technical investment dissertation, nor or we accountants, so we always advise consulting your tax and legal experts to better dial in your investment strategy.
<u>That said… we are not new to the game.</u>

Using the following assumptions:

Current Market Value: $300,000 ($40k land, $260k building)
Purchase Price: $200,000
Financing: 20% down ($40K), 6% interest rate, 30 yr fixed amortization
Owners in **30% tax bracket**

1) **<u>Principal Paydown</u>**: This often-overlooked factor is one of the most important. Assuming we originally put $40k down for the property, in Year 1 alone, we have already paid off $1,964 in Principal. **<u>This yields a 5% return</u>** on the original $40k investment. In Year 10, this jumps to 8%. Another way to think of it is this… you would need a 5% guaranteed investment in the stock market to equal Principal paydown on your rental real estate alone.

2) **<u>Deductibility of Expenses</u>**: For your primary residence, you are only able to deduct Mortgage Interest. For your rental, you are able to deduct other expenses, such as property taxes, insurance and maintenance expenses.

   Expense Assumptions
   Property Taxes: $2,000
   Insurance: $1,000
   Maintenance: $1,000

   $4,000 * 30% tax bracket = $1,200 / year post-tax return… **<u>another 3% return</u>**

3) **<u>Depreciation Expense</u>**: Depreciation is the process used to deduct the costs of buying and improving a rental property. Per the IRS, instead of taking one large deduction in the year you purchase the property, depreciation distributes the deduction across the "useful life" of the property… for residential real estate, 27.5 years.

Assuming a current assessed value of $300,000 ($40k of which is the land, $260k the building), the math works like this: $260,000 / 27.5 years = $9,455 annual depreciation expense. Give the 30% tax bracket of our example owner, this yields another $2,836 of post-tax cash benefit… **a 7% return on the original $40k down**. While depreciation expenses will eventually have to be recaptured once the property sells, many investors delay this indefinitely by selling the rental property as a part of a 1031 exchange. Regardless, the cash is the owners until they sell the property.

4) **Appreciation**: For a fixed-rate loan, as property values increase, so does the owners net worth. This is due to the fact that, even though taxes and insurance will increase over time, loan Principal and Interest will remain fixed. Assuming a conservative 3% annual appreciation on the property, this adds a pre-tax gain of $9,000/year. Again, factoring in the owners 30% tax bracket, this yields **ANOTHER $2,700, or 7% return.**

5) **Other factors, good and bad**:
   a. Rental ROI: Depending on the original financing and hold period, the rental will hopefully generate positive cash flow. This is powerful, but not included in this analysis. Over time, this cash will become an important annuity adding funds for retirement or other investing goals.

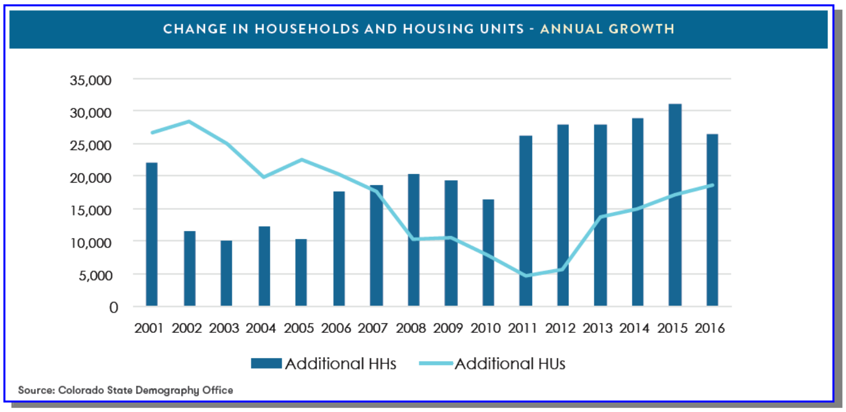
   b. Vacancy Rates: In most situations, an investor should factor in a 5% vacancy rate, in which no rent will be coming in. This impacts a. above.

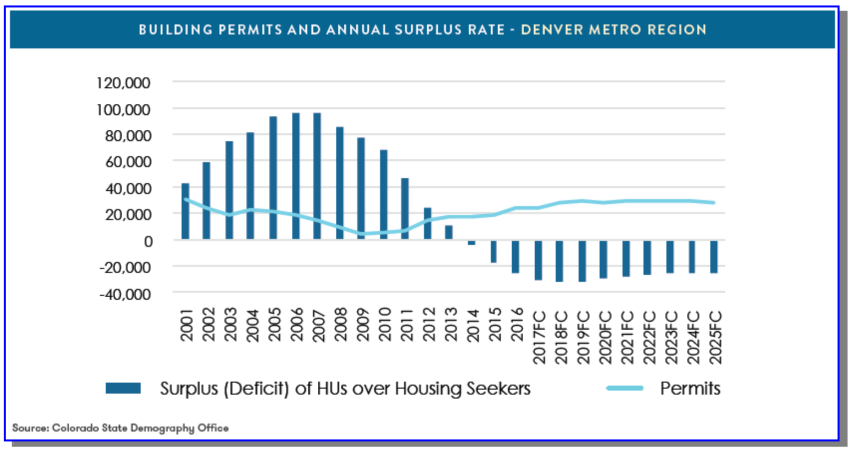
   c. Inflation: Every year, the cost of living increases, leaving our current $ worth less. Many investors in 'normal' real estate markets simply offset Appreciation with Inflation (both about 3%), to assess long-term impact of holding the investment. In higher-growth areas like the Front Range of Colorado, Appreciation will likely outpace Inflation.

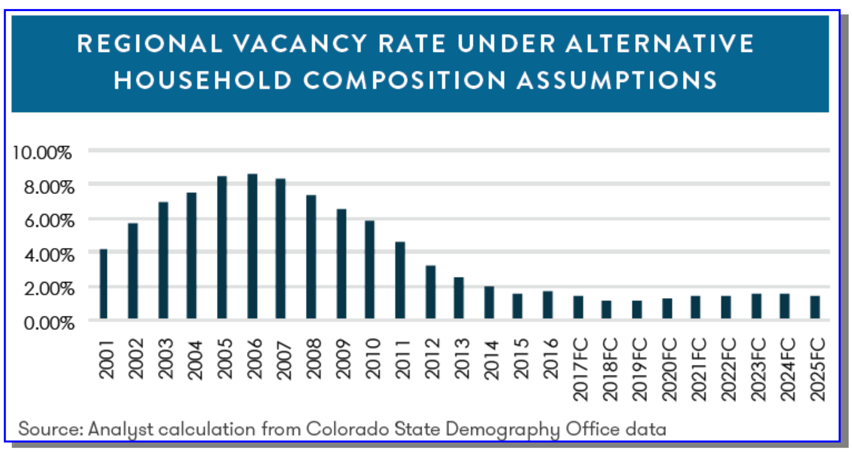
Where does this leave Denver-area real estate investors? There is no doubt that the Front Range of Colorado has become a highly desirable spot across the country. Over the past decade, Denver has transitioned from a regional hub into a true international city. This, in addition to its high quality of living, access to transportation and quantity/quality of the workforce, is causing many large corporations to move their headquarters to Colorado. It is also attracting progressive young professionals, mid-career families and retirees from across the country.

That said, for the foreseeable future, the Front Range will still have a dire housing shortage.

In an article published by The Denver Post in January of 2018* Denver's chronic housing shortage alone could take over 10 years to correct, according to a study conducted by Shift Research.







The charts to the left from the Colorado State Demography Office** illustrate the massive amount of under-building that has occurred over the past decade, as well as the correlating amount of under-permitting to correct this shortage (HHs=households, HUs=housing units).

Also shown is the forecasted vacancy rate that will likely result over the next half decade +.

For Denver rental property owners then, it <u>is</u> and <u>should remain</u> an incredible time to be a landlord well into the future.

<u>Sources</u>
**https://www.denverpost.com/2018/01/28/denver-chronic-housing-shortage-fixes/*

***http://www.shiftresearchlab.org/sites/default/files/2018-01/Housing%20Unaffordability_Final_Report_11.26.18_0.pdf*