An Overview of Real Estate Investment Models, Part 1 of 2

By Larry Shafer, Dade Real Estate Investor Association Member

Beginner real estate investors are presented with a multitude of investment options. These options include primary residence investment, buy and hold income investments, property rehabilitation, and pre-construction investments. The goal of this article is to introduce these basic real estate investment options, and to present a common investment evaluation structure that will hopefully help the reader become better informed about the financial benefits of each investment model.

About the Author

Larry Shafer is a Principal of MarketScience, and a Florida licensed Realtor and mortgage broker. Mr. Shafer is also a full-time real estate investor.

Please note that this introduction is not intended to be comprehensive. A comprehensive discussion of real estate investment models would include additional options such as wholesaling, lease options, condominium conversions, tax liens, spec homes, land banking, real estate development, and much more. Many of these investment models require considerable expertise. Because this article is directed at the beginner real estate investor, we are limiting the scope of this discussion to the most basic real estate investment models that are easily accessible to the entry-level investor.

The Financial Benefits of Real Estate – Introducing 'CATE'

Before we get started with the different fundamental real estate investment models, it will be helpful to lay out a framework for understanding the financial benefits of investing in real estate.

Many entry-level real estate investors are moving away from the most common investment option available to investors – investment in the stock market. To put it simply, stock market investment is primarily an asset appreciation game. Even though the federal government passed a law lowering the tax on corporate dividends, the market is still driven by investors looking to make money by having their shares appreciate in value.

Unlike stock investments, real estate investments can offer a larger set of financial benefits, including substantial income, tax benefits, and equity buildup in each property.

These financial benefits can be easily remembered by the acronym '**CATE**' –

- **C** is for **Cash Income**
- **A** is for **Asset Appreciation**
- **T** is for **Tax Benefits**
- **E** is for **Equity Buildup**

The following table describes each financial benefit in more detail.

Letter	Financial Benefit	Description
C	**Cash Income**	Some real estate investments throw off substantial operating income – the difference between the gross rents and the monthly expenses.
A	**Asset Appreciation**	Most properties rise in value over time, delivering asset appreciation to investors.
T	**Tax Benefits**	The IRS provides considerable tax benefits for real estate investments. These benefits include depreciation, tax-deductible mortgage interest, primary residence exemptions, and 1031 tax-free exchanges.
E	**Equity Buildup**	Real property investments financed with a traditional amortizing mortgage will experience equity buildup as the principal portion of the mortgage payments is applied against the loan balance.

We will now use my CATE analysis to describe the financial benefits of each basic investment model. For each investment model, we will also touch on some of the core strengths, weaknesses, and challenges of each different investment type.

This article continues on the next page…

Primary Residence Investment

Purchasing one's own primary residence is an excellent initial investment for the beginner investor.

CATE Financial Benefits Analysis

Financial Benefit	Description
Cash Income	While primary residences are often fully occupied by one family with no renters, primary residences can produce cash income via room rentals. In addition, multi-family primary residences (duplexes, triplexes, and fourplexes) can provide rental income via renting units that are not occupied by the family.
Asset Appreciation	Every month, the primary residence will go up in value along with the rest of the market.
Tax Benefits	The IRS allows individuals to take $250,000 in tax-free gains from the sale of their primary residence once every two years. The exclusion is $500,000 for couples. The IRS also allows primary residence mortgage interest to be deducted from ordinary income, reducing the investor's overall tax burden each year.
Equity Buildup	Monthly payments on a traditional mortgage contain a principal component. Every month, the investor pays down the mortgage amount and builds equity in this way.

Strengths

- Owning a primary residence allows the investor to stop paying rent. This allows the investor to build equity and experience market appreciation instead of the landlord.
- Rehabilitation of a primary residence can be easier because the investor lives there.
- Financing programs are quite favorable for primary residences.
- Primary residence investment is an easy first step for beginners.

Weaknesses

- This investment model doesn't scale up – you can only have one primary residence.

Buy and Hold Income Investment

The purchase of 'buy and hold' income investment property is a logical next step for the primary residence homeowner who is ready to build a real estate portfolio. While buy and hold income properties can be commercial, retail, or industrial, most buy and hold income properties purchased by beginner investors are residential apartment buildings.

CATE Financial Benefits Analysis

Financial Benefit	Description
Cash Income	Income rentals should produce a monthly cash income – the difference between the total rents and our mortgage payments, taxes, maintenance, and operating costs.
Asset Appreciation	Income properties go up in value over time, just like primary residences. The growth in property value is most often tied to increases in rents and income, but sometimes the growth in value is based on other factors.
Tax Benefits	The IRS allows investors to depreciate income property over the course of a number of years to account for wear and tear on the property. This depreciation allows investors to shield ordinary income. In addition, there may be other tax benefits for owning and redeveloping low-income income property in developing areas.
Equity Buildup	Every month, renters pay down the mortgage on a rental property. Over time, this equity buildup can be tapped for additional property investment. If the property is held for the term of the mortgage, the equity buildup will be complete, allowing the investor to enjoy the entire rent payment as profit (less expenses).

Strengths

- Buy and hold income investment has the most comprehensive suite of financial benefits, including cash income, asset appreciation, tax benefits, and equity buildup from rent payments.
- Buy and hold income investments create highly valuable passive income streams.
- Buy and hold income investments have flexible improvement and exit options. Properties can be converted to condominiums or the investor could improve the property to increase rents.

Weaknesses

- Buy and hold income investment is typically cash intensive. Most conventional rental income investments require 20% down-payments from investors.
- Buy and hold income investments must be managed. Tenant issues may be time consuming and frustrating for some investors.

This article is the first installment of a 2-part article titled **An Overview of Real Estate Investment Models**. The conclusion of this article will include coverage of the property rehabilitation and pre-construction investment models. The full text of this article is already available on http://www.marketscience.com/.

An Overview of Real Estate Investment Models, Part 2 of 2

By Larry Shafer, Dade Real Estate Investor Association Member

This article is the second installment of a 2-part article titled **An Overview of Real Estate Investment Models**. The first part of this article introduced a model for analyzing the financial benefits of real estate, as well as the primary residence and rental investment models. The full text of this article is available on http://www.marketscience.com/.

In the first part of this article, we introduced my CATE Analysis – a way to quickly analyze and summarize the financial benefits of a particular type of real estate investment. Let's recap this before we analyze the property rehabilitation and pre-construction investment models. These financial benefits of real estate can be easily remembered by the acronym '**CATE**' –

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E	**Equity Buildup**	Real property investments financed with a traditional amortizing mortgage will experience equity buildup as the principal portion of the mortgage payments is applied against the loan balance.

We will now use my CATE Analysis to describe the financial benefits of the property rehabilitation and pre-construction investment models. For each investment model, we will also touch on some of the core strengths, weaknesses, and challenges of each different investment type.

Property Rehabilitation Investment

Property rehabilitation can be one of the most exciting investment models available to the beginner investor. Property rehabilitation involves the purchase, rehabilitation and renovation, and profitable resale of a property within a short period of time. This investment model may also be referred to as 'fix and flip', 'property rehab', or simply 'rehab'.

CATE Financial Benefits Analysis

Financial Benefit	Description
Cash Income	Property rehab typically carries no cash income benefits. Sometimes a rehabber will put a short-term tenant into a property, but this tenant will typically just cover the monthly costs of the property.
Asset Appreciation	Asset appreciation is the name of the game in property rehab. Rehabbers create quick asset appreciation by buying a property below market value, renovating it quickly and inexpensively, and then selling the property at a considerable profit.
Tax Benefits	The tax benefits of property rehabilitation are limited. Unless the rehabber exchanges the profit from the rehab transaction to a new property purchase using a 1031 exchange, the profit will be considered a short-term capital gain, or worse… ordinary income.
Equity Buildup	Because there is typically no renter in a property rehabilitation investment, no equity is accumulated from the payments on the mortgage.

Strengths

- A considerable amount of equity can be built within a short period of time via successful rehab investments.

Weaknesses

- Significant time and effort is required to find and negotiate properties below market value.
- Significant time and effort is required to architect, design, and renovate properties.
- Although there are ways to get started with limited capital, property rehabilitation generally requires considerable capital for down-payments, property renovation budgets, and the monthly carrying costs required before the renovated property sells.

Pre-Construction Investment

Pre-Construction Investment involves entering into a contract to purchase a property, typically a condominium, from a developer at a set price. The investor places a deposit into escrow at the time of contract signing, and is required to make an additional deposit at a future date. The investor has the right and obligation to purchase the property at the contract price when the developer has completed the construction. The investment proposition is primarily based on speculation – the investor believes the actual market value of the property at the time of completion will be higher than the contract price between the investor and the developer. The pre-construction investor hopes to resell his contract at a profit to another investor or to an owner-occupier who will occupy the unit when the building is completed.

CATE Financial Benefits Analysis

Financial Benefit	Description
Cash Income	There is no cash income from a pre-construction investment, because there is no renter to provide rental income.
Asset Appreciation	Pre-construction investment can provide asset appreciation, as the investor can sell their contract to another person for a higher amount of money.
Tax Benefits	There is no depreciation tax benefit on pre-construction contracts because there is no real property – the investment is only a contract and you can't depreciate a contract. There are no mortgage payments with deductible interest because there is no mortgage. In addition, you can't perform a tax-free exchange (also known as a 1031 exchange) on pre-construction contracts because there is no property – once again, the investment is only a contract.
Equity Buildup	With pre-construction, there is no equity buildup because there is no renter who is paying down a mortgage every month.

Strengths

- Pre-construction investment allows investors to speculate on future property values without the difficulty and expense of property management… because there are no tenants.

Weaknesses

- Investors who are unable to sell their contracts before the closing date are obligated to close and take possession of the unit. All of the traditional closing costs apply, and the investor is then saddled with a vacant unit in a building where the rental potential typically will not cover the carrying costs of the new property.
- Pre-construction investments carry a developer fee (typically 1.75%) that must be paid at closing.

Using CATE to Compare Investment Models

So far, we've introduced the CATE Analysis of financial benefits, and we've analyzed each basic investment model according to its key elements – **Cash Income, Asset Appreciation, Tax Benefits, and Equity Buildup.** Now, let's compare the attractiveness of each financial benefit according to the CATE Analysis. The following table presents my opinion of the attractiveness of each financial benefit, for the beginner investor. To create an easy to understand summary, I have indicated None if the investment model provides no financial benefit of that type, Low if the investment model provides very limited financial benefits in that category, Medium if the investment model provides average benefits in that category, and High if that investment model delivers exceptional financial benefits in that category.

	Financial Benefit	Primary Residence Investment	Buy and Hold Income Investment	Property Rehabilitation Investment	Pre-Construction Investment
C	**Cash Income**	None normally, High if you have renters	High	Low	None
A	**Asset Appreciation**	Medium	Medium	High	Medium
T	**Tax Benefits**	High	Medium	Low	None
E	**Equity Buildup**	High	High	Low	None

Please note that this summary is strictly my opinion of the financial benefits, and the financial benefits that you experience with property investments in each category may vary widely.

I hope this article has helped you better understand the primary investment models available to the beginner real estate investor.

Stay tuned for a future article titled **Elementary Real Estate Investment Strategy**. In that article, we'll use the CATE Financial Benefits Analysis and a variety of investor constraints and goals (including investable capital, risk, geography, time, desired gains, and liquidity) to devise a defensible portfolio strategy based on those constraints and goals.

About the Author

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