Why Invest in Real Estate (Part 1 of 3)

SPLAT

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There are many reasons why people choose to invest in real estate. These reasons can be narrowed down to about five main financial reasons and can be described using the acronym "SPLAT."

S	Safety (Capital Preservation)
P	Periodic Return (Cash Flow)
L	Leverage (Using Borrowed Funds)
A	Appreciation (Hedge Against Inflation)
T	Tax Advantage (Income Tax Shelter)

As a property manager, it is helpful to know what primary reasons our investors have for investing in real estate. For instance, if Safety or Capital Preservation is their primary motivation, then we need to manage accordingly. For instance, by minimizing risk and perhaps increasing the insurance coverage. Whereas, if the primary concern is Periodic Return or Cash Flow, then we might look more at deferring capital projects, while trying to aggressively push rent increases. There is certainly a lot of overlap and it can be a balancing act, but it does help management know how to best manage and where to focus our attention.

Besides the primary financial motivations for investing in real estate, there are four main ways that you actually make money in real estate. You might be thinking to yourself that you thought there were tons of ways to make money in real estate. Well yes, but technically all the ways you make money in real estate can be reduced to these four basic types of investment returns: Cash Flow, Appreciation, Loan Amortization, and Tax Shelter. I will talk more in depth next month about these four.

Lastly, after covering the why to invest and looking at what types of income real estate generates, that brings us to the "How" question. How to know you have a good deal? How to know the returns you are getting are good? What is a good deal and how do you calculate it? There are several ways to determine this, such as figuring out the Gross Rent Multiplier (GRM), or calculating the Cap Rate, looking at the first year return on your cash investment (Cash-on-cash), and lastly, some of the more technical metrics, such as DCF, IRR and MIRR (Discounted Cash Flow, Internal Rate of Return and Modified Internal Rate of Return), etc. These metrics will tell you a lot, but determining if it is good or not has a lot to do with how it compares to other available and potential deals…I will talk more about these metrics in an upcoming article as well. Remember that the numbers are only part of the deal analysis. A good property evaluation is critical, as well as a good look at the financial reports. A good checklist or property questionnaire can be useful, and a great Real Estate Agent and Property Management Company can be invaluable.

Happy Investing!!!

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