The Loan Debate

Consider the pros and cons of using different approaches to real estate financing.

BY ALI BOONE

One of the most passionate debates in the real estate industry concerns the risk in buying a property using all cash or purchasing it using leveraging.

Those who leverage their properties boast that the benefit of doing so allows the investor to buy more properties with the same amount of money. Those who pay cash come back against that argument, citing the riskiness associated with wondering aloud whether the risk is worth it, even if it does net more properties.

Neither position is disputable, creating a stalemate in the ongoing debate: Is leveraging riskier?

"Leveraging" at its essence is using "someone else's money" to buy something. It could include loans from banks, loans from individuals, credit-card financing and borrowed money.

For the purpose of this debate, leveraging mortgages is the example used because it serves as a strong example of long-term perspective (not short-term gain). A mortgage isn't the only way to finance a property, but it's the primary one—and a lot easier and more common than other methods.

Using Leveraging

Following are issues that should be considered when measuring risk associated with a property loan:

Cost. A large concern with leveraging anything is that interest inevitably will be charged, which raises actual cost significantly compared to the original purchase price. That extra cost can be quite substantial, depending on loan terms.

Losing what you put into it. For example, when buying a home with a 30-year mortgage, it is hard to know what challenges will arise throughout the loan term. What if the homeowner loses his or her job during the 20th year and struggles to find a new job? Unless that homeowner has a lot of money saved, they eventually will miss monthly mortgage payments. The bank will then take ownership of the house, and all the payments (principle and interest) for 20 years are for naught, never mind their credit being left in shambles.

Losing additional assets. Not paying the mortgage means not only losing the house to the bank, but also having the bank take other personal assets (unless you have a non-recourse loan) to pay for the loss. Luckily, most mortgages now are non-recourse, meaning the only thing they are allowed to take is that particular piece of property.

Loan terms. Having loan terms that escalate monthly payments through adjustable-rate mortgages (ARM) can be problematic, as well. Should they climb dramatically, the house could be lost. Fixed-rate mortgages lock in at the same interest rate for the entire length of the loan.

Miserable as they are, if those were the only sides of the story, buying with cash sounds attractive; however, investment properties can work slightly differently than a primary home. When investment properties are bought correctly, much of the risk can be mitigated, making leverage a less-risky strategy than all-cash transactions.

Risk Mitigation

Cost. As long as the mortgage payment (which includes the interest payment) is well-covered by the monthly rent collected for the property, this extra expense does not come out of the investors' pocket. Yes, interest still must be paid, but when comparing the cash-on-cash return of properties financed vs. all-cash purchases, returns are usually significantly higher, so more money is made than if the property was bought with all cash to avoid paying interest.

Losing what you put into it. Same scenario as before: after 20 years of owning a property, something drastic happens that prohibits the mortgage payment from being made and the home is lost to the bank. If you are a smart investor and the property created steady cash flow during the entire time it was owned, even if the bank takes it over all that is lost with an investment property is a diminished credit score. All that originally was invested was the down payment and closing costs, and the residents' monthly mortgage helped to pay those costs years ago. This mitigation is of huge consideration when buying an investment property vs. a home in which to live.

Losing additional assets. Never get a loan that isn't non-recourse. For a mortgage, this shouldn't be a problem, but always make sure it's included in the terms.

Loan terms. Never get an adjustable-rate mortgage; always get a fixed-rate. With the fixed-rate interest included, your payment should be well-covered by the rent collected on the property.

So assuming the rental property purchase was done wisely, what else could go wrong?

Paying Cash

Consider a rental property priced at $105,000 that brings in $1,150/month in rent. Total monthly expenses (including estimates for vacancy and repairs) are $376. This results in bringing home $774/month in profit. For an all-cash buy on this property, the cash-on-cash return calculates to 8.84 percent.

Now take the same property and finance it instead of paying all cash. If you arrange for a fixed-rate 30-year mortgage at 5 percent interest, the monthly mortgage payment will be $450.93. Add that to your monthly expenses and you will bring home $323.07 each month. It sounds like a lot less than the $774 from the all-cash buy, but remember: Instead of putting $105,000 of your own money into this, you only put $25,000 or so in as a down-payment. So your cash-on-cash return figures higher at 14.77 percent. That's nearly double the returns earned by paying all cash.

What if this property suddenly goes completely bunk? You know it hasn't done so because of an adjustable-rate mortgage because it has a fixed-rate mortgage. Clearly, the apocalypse must have occurred in the neighborhood, which perhaps went sour for some uncontrollable reason. The property is now "done."

For both scenarios, consider what is lost:

1. Had it been an all-cash transaction, you are out $105,000 cash (less any profit you made along the way).
2. If the property was mortgaged, you are out $25,000 cash (less any profit you made along the way) and your credit score/ability because you had to foreclose.

Which sounds better? Many would answer option two, but to each his own.

The Verdict?

Using leveraging means investors can buy properties at roughly one-fifth of the cost compared to all cash. Doing so means returns are higher and tax benefits are substantially greater. And, owners are more covered for vacancy and repair issues because having more cash flow as a result of owning more properties helps to cover those expenses.

Then, if all goes south, only one-fifth is lost compared to all-cash transactions. The major difference in this comparison is risk to the credit score.

What if the property's value drops significantly and now more is owed on the mortgage than what the house is worth? Easy. Property value doesn't matter unless the goal is to sell the property.

What if the investor is forced to sell and the property is underwater? If the investor does not have the money to make up the difference, they choose foreclosure and all that is lost is their credit score. Had the property been purchased with all cash, the investor loses the full difference between the sale price and what they paid for it. That could be tens of thousands of dollars.

Ali Boone recently left her corporate job as an Aeronautical Engineer to work full-time in real estate investing. She began two years ago and has bought five properties in an 18-month period, using creative financing methods.

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