Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

**Real Estate Investment Newsletter – May 2003**

## Opportunity Costs and the Average Investor: A Look at Some Potential Pitfalls in Real Estate Investing

Having earned masters degrees in both economics and finance, I was taught some truly useful ideas that somehow never seem to have propagated into the general population. This month I will do my part to explain a concept I believe is key to maximizing wealth over a lifetime: opportunity costs. Most economic models assume that everyone already uses this concept in making decisions. Unfortunately, in real life, decisions are seldom analyzed with this tool. Consequently investors do not do as well as they could.

So what is an opportunity cost? It is not a true cost in the normal sense; there is no cash payment of an opportunity cost. Rather, it is a benefit you could have received but did not because you made a different choice. For example, if you give up one job to take another, the salary you would have received in the job not chosen is the "opportunity cost" of taking the new job. If the job taken has a higher salary than the job foregone, then benefits exceed opportunity costs and you maximize income (ignoring non-monetary benefits). Most people intuitively figure out this simple analysis for a known alternative. But what if there is another job available that has even higher pay, but is unknown? In this case, opportunity cost is higher than benefits of the job taken and income is *not* maximized. Fortunately ignorance is bliss and we don't feel bad about opportunity costs unknown to us. Still it may be worth seeking to understand these opportunity costs so as to make better decisions – especially when it comes to investing hard earned capital. (Hence, this newsletter).

My main point here is that investors need to first identify their true alternatives and estimate the benefits of these other possible choices before they can make the *best* decision. What do I mean? Let's look at some real estate investing situations to see the pitfalls of myopia. First is a qualitative analysis of opportunity costs, then a more quantitative one.

### Choosing a Broker/Investment Advisor - Accidentally

OK I'll admit it – this is my pet peeve. Still it merits your attention because the benefits of using the average real estate broker to represent you can be substantially less than opportunity costs (i.e. the value of an alternative choice). Here's how it happens. You see an advertisement for a property and the listing broker (the one who is marketing the property for the seller) shows it to you. If you like it, the listing broker will try to convince you that he can "help" you with the purchase and that you don't need your own broker representation. (This way he gets the whole commission and doesn't need to pay for your broker). If you don't like the property, he wil l offer to show you other properties for sale (listed by other brokers) in the area. Either way, if you accept, you've chosen your broker.

If you buy the property listed by the broker and you agree to let him help you with the transaction, you have given up your right to have a broker who works for you. Legally the listing broker can only represent the seller's interests and cannot represent yours unless the seller gives permission (which they shouldn't). This means you must do your own negotiating (no professional advice), your own due-diligence, and your own financial analysis. He may offer to help with this, but be warned: he will not do anything that could help you at the expense of the seller. The opportunity costs are clear:

- No expert advisor to warn you of unfavorable or risky deal terms
- Many hours of your time spent doing work that an investment advisor could have done
- Potential for the purchase to turn out much less profitable than expected because of incomplete investigation and analysis

If you turn down his property but allow him to show you properties listed by other brokers, he becomes your representative. You will ***not*** be able to bring in someone else to work for you if he shows you a property you like. At least in this situation you have representation, but how do you know what he will actually do for you? If he is like most salespersons, he will do only the minimum required to close the sale. The following table provides a comparison of using Berkeley Investment Advisors as your dedicated broker for investments versus what you get from the average (accidental) agent.

| | Berkeley Investment Advisors | Average Real Estate Salesperson |
|---|---|---|
| Property Pre-Screening | Eliminate properties that are unlikely to meet risk and return goals | Show everything in the price range - in order of geographic convenience |
| Initial Due-Diligence | Investigate market rents, vacancies, insurance costs, property taxes etc. | None. Provide unsubstantiated opinion as to rents and vacancy. |
| Financial Analysis | Detailed projection of net operating income, financing costs, free cash flow, and return on investment. | Compare per unit prices to recent sales. Accept listing broker pro-forma income as truth. |
| Terms Negotiation | Structure all terms of offer to minimize risks identified. | Focus on price negotiation, possibly financing terms. |
| Final Due-Diligence | Review leases, operating ledgers, insurance losses, inspection reports, etc. Recommend re-negotiation or other remedies for problems. | Pass documents to buyer. Recommend inspection professionals and minimize impact of any findings. |
| Financing | Shop for best financing. Provide information to lender and appraiser to increase likelihood of loan approval. | Refer to loan broker. |

The advantages to pre-selecting Berkeley Investment Advisors are clear:

- Time savings
- Reduce risks and eliminate reliance on gut instincts
- *Know* whether the investment can meet your financial goals
- Higher probability of completing a deal that works for you

The bottom line to this example is: Make your decision about who to use as your broker based on the value they will provide over the course of the whole transaction as compared to your other opportunities. I.e. know your opportunity costs and use that knowledge to maximize benefits to you.

## Passive Investing: Inaction Can Cost You Real Money

In talking to many investors I find a complacency about their existing investments that is downright irrational when you consider the opportunity costs. Symptoms: under-leveraged property, holding property whose value has increased substantially more than its cash flow, singular focus on nearby real estate. The cure: compare what you're doing to what you could be doing. Once you know the alternative investments available, ask yourself: Would I buy my property today at its current value? If the answer is no, you should be a seller. Let's look at this with a quantitative example.

Suppose you bought the median priced house in Berkeley California for $268,000 in 1996 with 10% down. At the end of 2002 you buy a new house and keep the old one as a rental. At this point the old house is worth 492,000, a gain of 224,000, but it can only be rented out for $3,000 a month. Annual net operating income for this rental is calculated as follows:

| | |
|---|---:|
| Scheduled Gross Rent | 36,000 |
| Vacancy Allowance 6% | (2,160) |
| Effective Gross Income | 33,840 |
| Less: | |
| Property Taxes | 3,380 |
| Insurance | 3,960 |
| Repairs and Maintenance | 2,000 |
| Other | 500 |
| Net Operating Income (NOI) | 24,000 |

Note the valuation metrics here: the Gross Rent Multiplier (Price/Rent) is 13.7 and the capitalization rate (NOI/Price) is 4.88%.

Assuming a 30 year fixed rate mortgage at 5.75%, this property would have breakeven cash flow at a loan amount of 343,000 – 70% of value. For this example let's assume you are somewhat under-leveraged: you paid down your original mortgage and refinanced so that your current mortgage is only $214,000. Your payments would be 15,000 a year and you would be enjoying positive cash flow of 9,000 a year. I think most people would be pretty happy with this investment. After all they had a cumulative return on investment totaling 937%[1] over 6 years, and the current cash flow is just icing on the cake. Rental property owners in the Bay Area would have a similar situation – though somewhat lower returns on investment (because of lower leverage) and higher current capitalization rates.

The problem with continuing to hold the investment is that it is highly unlikely to generate these kinds of returns over the next 6 years. In order to do so, the cumulative return would have to be 2,605,000 (937% of current invested equity of 278,000). Suppose prices rose another 224,000 in the next 6 years: roughly 6% annually compounded. This is far higher than expected increases in incomes and could only be sustained by further

[1] Calculated as (492,000-214,000)/(10%*268,000) -1

mortgage rate reductions or in-migration of richer people. If prices do repeat their rise, what will the return on the invested capital be? Adding the cash flows to the appreciation gives a roughly 100% return forecast for the next 6 years – 12.3% compounded annually[*]. If this happens great, but no one can safely predict that prices will continue appreciating at this rate. In fact, economic logic suggests a period of much more sluggish growth after such a fast run-up relative to incomes (which probably rose no more than 24% during the prior 6 years).

A less aggressive assumption about the future would be 3% appreciation – in line with expected income gains. This, combined with the cash flows would produce annual compounded returns of about 8.4%*. Still not bad in an era of 1% money market rates, long bond yields under 3.5%, and a mostly down stock market. But wait, this article is about opportunity costs. Remember?

What are the opportunity costs in this case? My example comes from last month's newsletter: *Northwinds is a 24-unit property right on the strip in Las Vegas, priced at $895,000. The investment required would be approximately $259,000[2] if a loan for 75% of value can be obtained.* In comparison to the house, the valuation metrics on this property are much more favorable. Gross rents are $135,000 making the GRM just 6.6. Net operating income is expected to be $76,700, implying a capitalization rate of 8.6%. With 30-year 6.5% fixed-rate financing, this property will generate free cash flow of $25,800 – almost 3 times that of the house.

What about appreciation in Las Vegas? If anything it should be higher than the Bay Area. Las Vegas is the fastest growing big city in the U.S. It led the nation in job growth last year with a 3.9% gain and growth should accelerate to 5.5% this year. Meanwhile a recent Wall Street Journal article pointed out looming supply constraints. Land prices have been increasing 15% annually over the last 5 years. Even so, prices and rents are at very reasonable levels compared to the Bay Area and have plenty of room to grow. The average advertised monthly apartment rent at the end of 2002 was only $722 in Las Vegas versus $1,254 in Oakland CA (next to Berkeley). I expect Las Vegas apartments to appreciate at least 5% annually over the next 6 years, possibly more.

For the sake of comparison, lets assume rents and prices in Las Vegas only match my conservative estimate for Berkeley: 3%. Given this, how do the total returns compare? Combining appreciation with cash flow, the

[*] My calculations include principal pay downs and 3% annual increases in NOI.
[2] This includes 17,000 estimated closing costs and 18,000 as working capital for operations.

apartments will generate a 6-year return of 152% on the initial investment. This equates to 16.6%* compounded annually – roughly twice that of the house. If, as expected, the Las Vegas apartment rents and values rise at 5%, the returns on the apartment investment would exceed those on the house by $359,000 over 6 years. Thus the opportunity cost of continuing to hold the Berkeley house as a rental are quite high once we look to see the alternative investments available: we'll be $359,000 poorer by doing nothing as compared to pro-actively managing our capital to maximize returns.

## Conclusion

Opportunity costs are real. Not knowing them means you may end up much poorer than you could have been. Of course it won't be very painful since you won't realize what you could have achieved. Ignorance truly is bliss, but knowledge is an earlier retirement. Maximize your income by evaluating your Broker/Investment Advisor carefully ***before*** making your choice. Berkeley Investment Advisors can help evaluate your opportunity costs to show you the way toward maximizing returns and minimizing the time till retirement. Isn't that what it's really all about?

## Featured Investment Opportunities

This month I want to highlight 2 Southern California mobile home parks. The first is 32-space park in Los Angeles County with 3 apartments and 29 park owned mobile homes. This park is priced at $1,180,000 with a capitalization rate of 9.2%. The required investment of $400,000 should yield a (pre-tax) cash-on-cash return in excess of 11%. The second park is in San Bernardino county California. The price of this 47-space park is only $850,000 and the capitalization rate is a huge 10.1% - even at 10% vacancy. The $390,000 required investment should yield a (pre-tax) cash-on-cash return of more than 14%.

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