Essay by **Orlando Cuello** (*):

THE RENTAL PROPERTY

The Star Niche of Real Estate Investment (R.E.I.)

INTRODUCCION:

The present essay has the purpose of guiding the standard Real Estate investor in their investment decisions, through a combined analysis of theoretical support and direct experimentation. Said analysis will be based mainly on the learning derived from the professional praxis of the author in his capacity as Construction Architect and Residential Appraisal Instructor in the State of Florida.

GENERAL VIEW:

The world of Real Estate has a very broad field of operation where very heterogeneous actors intervene both in their role and in their impact. Imagine an immense bright sun around which many satellites orbit: the seller (seller), the buyer (buyer), the real estate agent (realtor), the lender (lender), the mortgage broker (mortgage broker), the appraiser (appraiser), Title Company (Title Co.), Insurnace Company (Insurance Co.), Home Inspector (Home Inspector), surveyor (surveyor), Investor (investor), Developer (developer), the Builder (builder), the City Hall (City Hall) ... plus another collection of secondary actors that provide support to those already mentioned, such as sub-contractors and the condominium management and maintenance companies. The web of interconnection that is woven between these actors becomes so dense that it is sometimes difficult to differentiate its limits.

Within this panorama, the investor is one of those actors, who like everyone else, participates by biting a portion of the cake, the size of which will depend on the type of investment they have chosen. That choice is, almost always, adjusted to your own mental "logic".

THE "LOGICAL" BEHAVIOR OF THE INVESTOR:

The specialized Real Estate investor invests his money using the available information obtained from the business environment. In this process he puts more brain than heart, as well as the corresponding and inevitable dose of intuition.

The average real estate investor also uses the information available wisely and, of course, tries to make his decision lead him to obtain the best possible results. And since he considers himself a sensible investor, he also puts more brain than heart in running his business. But generally you have a tendency to use an action logic as "investor" similar to the action logic you use as "person." That is the reason why we see many investors buying houses at the price of skinny hen in order to "seize" the opportunity that this "buyer's market" offers. This "logical" behavior is what we refer to when investors buy current properties instead of buying "Income Properties" or "Rental Properties", to which we will refer later.

THE TYPES OF APPRAISALS:

One of the many approaches to the issue of Appraisal (Appraisal) defines it as "the sustainable estimate of the value of a property, expressed in money." The professional practice of the Appraisal is based on the principles of economic theory, which makes its theoretical foundation, its thematic and its methodology quite complex. However, we are only going to make a nominal reference to the most widely used appraisal methods today, for which we are going to divide them into two large areas: the appraisal of the PROPERTY (land) and the appraisal of the IMPROVEMENTS (construction).

According to the book entitled "Fundamentals of Real Estate Appraisals" (9th Edition, by William L. Ventolo & Martha R. Williams), to approach the estimation of the value of a PROPERTY, we have six methods available:

1st) Sales Comparison Method,
2nd) Allocation or Assignment Method,
3rd) Extraction Method,
4th) Subdivision and Urbanization Method,
5th) Method of Capitalization of the Value of a Land (Ground Rent) and,
6th) Method of the Residual Earth.

According to the same text, for the **evaluation of IMPROVEMENTS, there are 3 basic methods:**

1st) Cost Approximation Process,
2nd) Sales Comparison Process and,
3rd) Process of Capitalization by Income.
For the first point (Cost Approximation Process), there are two edges to address the issue:
- **a) Reproduction and Replacement Costs and,**
- **b) Depreciation Costs**

The methods for calculating the Reproduction and Replacement Costs are four:

1st) Indexing Method,
2nd) Method of Feet or m2,
3rd) Method of Units or Components (Chapters / Breakdown) and,
4th) Total Quantitative Survey Method.

The methods to calculate the Depreciation Costs are also four:

1st) Method of Useful Life,
2nd) Method of Observed Conditions (Physical Impairment, Functional Obsolescence and External Obsolescence),
3rd) Capitalized Value Method, and
4th) Market Extraction Method.

As can be seen, there is a wide range of methods for an appraiser to support his work of estimating value and express it in money. And it is also easy to deduce that there must be a method that is the most appropriate for each type of property.

ANALYZING THE EXPERIENCES:

The beginning of the activities as Appraiser was the beginning to discover many surprises. The first was to check the notable difference between the profile and the requirements of an Appraiser who works in Colombia and a Licensed Appraiser in the State of Florida. In Colombia an Appraiser is generally chosen for his high professional prestige, which gives him a considerable technical background with which he theoretically supports his positions, which in turn give way to his final considerations and conclusions. In Florida the process begins with obtaining a License, the requirement of which is an exam and then continues under the supervision of another Certified Appraiser. In the development of his function, the Appraiser follows a squared and inflexible script, many times without understanding the principles that truly support the theoretical pillars of his conclusions of value. For the residential case, which is the most common, of the three methods used to assess the IMPROVEMENTS, the "Sales Comparison Process" method prevails, better known as the "comparable sales" method. This method is so well known and widespread, that many people do not believe that there is another valuation method. But you have already seen in the previous paragraphs that there are a lot of methodologies, besides this one.

Another important lesson that an unsuspecting viewer can derive from exploring the world of Real Estate is the diverse nomenclature of different types of properties. It is very American style to designate each thing by name. And in such an important field, such as Real Estate, it was to be expected that this would happen. It is not the case to make a detailed inventory of this classification, but it is important to point out the ones that interest us the most. While we in Latin America speak almost in generic terms of "houses" and "apartments", here we find a collection of names that at first contact with them leads to confusion. "Townhouses", "Villas", "Single Family", "Estates", are just some terms of this collection. When for example we say "apartments", they are generally units dedicated to rent. And when we want to refer to them in the sense of our mental conception, we are referring to a "Condominium" or "Condo", as they usually call it.

Here we find another important nomenclature for our analysis. It happens that in the United States there are many places where the injection of capital that people make when they invest in rental properties is stimulated with a tax relief. These properties are known by the name of "Income Properties", which literally translates to "**income properties**" or "rental properties". Or more precisely, "income generating properties or rent." These properties are known by the names "duplex", "triplex" and "fourplex". This is equivalent to saying "bifamiliar", "trifamiliar" and "tetrafamiliar". And here comes the nomenclature, because five or more units in the same building constitute a "multifamily", which is generally a set of apartments of five or more units dedicated to rent and which is governed by specific regulations.

And here comes another interesting detail: These 2, 3 and 4-unit homes have a different treatment when they are subject to an appraisal. While for a "Single Family" the prevailing methodology is that of "Comparable Sales"; In the "Income Properties", the priority methodology is # 3: "Capitalization Process by Income". This means that the predominant analysis in the theoretical support of finding the monetary value of this property is based mainly on the income that this property can generate. For that reason, this appraisal has a more complex format, since it not only analyzes the comparables of the SALES of similar properties, but also analyzes the comparables of the RENTS of similar units in the area. And at the end of the assessment, by way of conclusion, what is known as "Final Reconciliation" is done, which is the presentation of the three values produced by the three methodological approaches used in the assessment of the IMPROVEMENTS (Costs, Sales Comparison and Income Capitalization), or at least two of them. In this "reconciliation" the appraiser, to reach its conclusion of value, gives greater weight to the methodology that best applies to the type of property that is being appraised. For example, if it is a Single Family Home, the "Comparable Sales" methodology will be predominant. But if it is a "Triplex", for example, the "Capitalization by Income" methodology should be considered above all others.

LANDING ON THE ANALYSIS OF INCOME-BASED ASSESSMENTS:

Virtually all residential appraisal reports include the methodology known as "Comparable Sales". This method consists of selecting and analyzing a minimum of three sales of properties similar to the property that is being appraised. These comparables must meet certain requirements, such as the following: That the sale be what is known as an "Arm's Length Transaction", that is, a completely normal transaction. This means that it is not an auction sale, that it is not a sale between relatives that may distort the "market Value", that the sale is recent (no more than one year), that the comparable property is preferably located in the same neighborhood (maximum one mile away) and that the property is as close as possible to the object of the appraisal. After making the necessary comparisons and adjustments, the appraiser will estimate the value of the property based primarily on a method that compares sale values.

In the case of "Income Properties" the method of "Comparable Sales" is also used, but as a secondary method, since at the time of "Reconciliation" the greater proportional weight conferred on the method of "Capitalization by Income ", which is the most appropriate method for this type of property.

We said in the segment of TYPES OF APPRAISALS, that this professional practice is based on the principles of economic theory. And particularly the method of “Capitalization by Income” has a close relationship with the Financial Statement known in English as “Income Statement” and in Spanish with the names of “Statement of Losses & Gains” or “Statement of Income”. This Financial Statement reveals, as its name suggests, the economic result obtained in a specific period of time. It is basically made up of three parts: Gross Income, Expenses and Net Income. From there a mathematical equation is derived:

Gross Income - Expenses = Net Income.

And if we adapt this same formula to the business of rental properties, we find the following equation:

Gross Potential Income - Unemployment Margin and No Payment = Effective Potential Income - Operating Expenses = Net Operation Income (NOI)

From this conceptual analogy originated in the “Income Statement” and then adapted to the Real Estate business, the previous formula arises that allows a clear accounting management of the rental property business. After this accounting adaptation and after incorporating the interest rate variable used in financial mathematics into the business structure, a mathematical formula arises that allows calculating the commercial value of a real estate for rental activities:

NOI / Rate% = Property Value

Where the Rate is the% or the rate of return that the investor expects to obtain on the investment.

FINAL THOUGHTS:

- ❖ The cost of reproduction of a “Rental Property” compared to an ordinary residential property of similar areas, could be 20% higher, but the income potential of this same property will also be 40% or more higher.

- ❖ When an ordinary residential property is vacated, income decreases by 100%. When a “Rental Property” is vacated, income decreases, but only partially.

- ❖ The speed of placement in the housing rental market of the units that make up an “Income Property” is usually greater than the speed of placement of a current residential property, because due to its smaller size and price, it potentially reaches a population higher.

- ❖ The “Income Property” conceptually carries the idea of the long-term financial, so it is an appropriate model for those who seek a relatively uniform and predictable profitability for their future.

- ❖ Under an investment profitability perspective, the “Income Property” is constituted, in addition to being profitable in the long term, in an investment with a high appreciation rate in the short and medium term when the inventory is acquired or built in times of “Buyers Market”.

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