Using Leverage in Rental and Investment Real Estate

Many real estate owners once thought that the smaller the cash down payment on a piece of property, the better. Using borrowed funds, or **leverage**, may multiply the economic benefits of your investment.

Let's assume you buy a rental house for $100,000, paying cash. The house appreciates 10% the first year and is now worth $110,000. Your return is 10%. But suppose you use leverage, making a $25,000 down payment and borrowing the balance. Now, given the same 10% appreciation, your return is 40% because you've invested only 1/4 of the $100,000.

Leverage, however, can make real estate investing difficult during economic downturns. Suppose the house you buy *depreciates* 10%. The cash buyer will lose 10% of the value. The leverage buyer, however, will lose 40%.

In general, the more cash flow you seek, the larger the down payment you may want to make. A large down payment will lower your monthly mortgage charges, your closing costs, and expenses for title insurance, appraisals, and other assessments.

To save money on mortgages, you could ask the seller to provide a loan at a low interest rate or attempt to take over an existing mortgage, thus sparing yourself high closing costs. It is possible to make leveraged rental property pay but you must be careful. The rent you charge can make or break your investment. Charge too much and tenants will go elsewhere, too little and it will cost you money. How do you find the right level? To a large extent, the marketplace creates the rules. In a tight market, rents will rise to the level tenants are willing to pay. In a depressed market you may have to lower your rents just remain competitive.

Still, you may have some leeway. You may have a good landlord/tenant relationship and your tenants may love the apartment or they may like the area and dislike the idea of moving. In such cases, carefully raise your rents to give yourself more income for emergencies, judicious improvements, and some profit.

One unusual viewpoint expressed by an expert is that whenever your vacancy rate is lower than 5% in a multi-unit building, you're not charging enough. He suggests that rents be raised until your vacancy rate is 5%. Eventually, after you've dramatically increased cash flow and property value, your vacancy rate will rise to 5%.

The risk here, of course, is that by raising rents you may inadvertently raise your vacancy rate far above 5%. In addition, each geographic section of the country is subject to specific market conditions. You should always be in tune with the nature of the rental market in your geographic area before testing rental theories.

In addition to raising rents, look for other strategies to increase your profits. Install coin-operated laundry equipment, charge for additional storage space, or convert extra space into more rental units.

You may also reduce your expenses by installing insulation blankets over hot water heaters, re-caulking all windows, and avoiding expensive remodeling and redecorating.

Many experts believe that the time to purchase property is when times are hard. The time to sell is when occupancy rates are 100%, rents are up, and the building is generating lots of cash or when a wonderful bargain, a bigger, better property, is available and you need cash for a down payment.

It is important to remember to use leverage judiciously and to plan appropriately for rent increases as well as rental property betterments.

REILEVER-X