RUSSELL WALKER

Mastering the Mortgage and a Real Estate Investment

Jose is considering the long-term implications of purchasing a condominium in downtown Chicago. He expects to move to the suburbs at some point in his life or possibly even to another city as part of his career advancements. Transacting real estate involves large costs in closing and agent premiums. Ideally, he'd like to make his investment in his condo work over the long-term, so holding onto his condo after he leaves is a possible option. Jose's condo is located in a nice part of Chicago and would make an attractive real estate investment, he thinks. Jose has never been a landlord, but having been a tenant, he realizes that landlords are often concerned about cash flows. Jose would like to develop a cash flow projection (over many years) for placing his Chicago condo into rental mode. He recently paid $500,000 for the condo. His down payment was 20% of the sales price and his mortgage is $400,000. He knows that some assumptions are necessary in preparing his cash flow projections. He begins listing some of the major costs that will be incurred as a landlord.

Direct Real Estate Costs

1) Property taxes paid to the City of Chicago and Cook County involve various formulae, but he currently pays about 3% of the market value of the condo.

2) Hazard insurance on his condo is currently $900 annually. This price if roughly driven by the replacement price of the condo. Jose figures that insurance will increase in price as the property increases in value. At least the insurance will increase at the same rate as inflation, but likely tracks with the appreciation of the property.

To make things easy, his mortgage servicer collects monthly funds to cover his projected annual property taxes and hazard insurance through an escrow account.

Jose realizes (as a former tenant) that landlords need to make annual improvements and updates to keep the property fresh and attractive. He does want to manage the property in a manner that would be attractive to a working professional.

3) His research indicates that general upkeep, system maintenance, required painting and the like result in annual outlays by the landlord of 0.5% to 1.0% of the value of the property annually.
4) His condo association has projected that annual fees are calculated as the maximum of $5000 or 0.7% of the market value of the property (actually the tax assessor assessed value, which is assumed to be approximately the same as market value). This pricing, according the condo by-laws, will remain in effect for the next 30-50 years or until the condo association makes an adjustment.

Renting the Property

Jose's condo is a 3 bedroom - 3 bathroom, luxury condo, with a porch and nice view of the city skyline. Comparable properties currently rent for $3000-$3800 per month. He believes that his property can achieve that rent level and likely hit the upper end. He looks into the possibility of a management company handling the renter selection and rent collection. Most management companies take 7% of the monthly rent for offering such services. Jose is not sure if he wants to use a management firm yet, but would like to know the impact on the cash flow of his investment.

Property Appreciation

Jose realizes that a great many of his costs (insurance and taxes) are driven by the appreciation of his condo. Also, he suspects that as his property becomes more desirable (and more valuable) he can change more in monthly rent.

The current US real estate stock has undergone a massive adjustment in prices. Jose got to participate in this market as a buyer. Conventional wisdom in the real estate industry is that property in Chicago can be expected to appreciate at an annual rate of 1% to 2%. Jose figures that rent will move with that appreciation, too, but perhaps a bit more, say up to 2.5% annually as his property is a bit more desirable than average condos in Chicago.

Analysis

Jose needs to know how much money will be required on a monthly basis to support the property. If he moves in the future, what can he expect with regards to his condo?

1) What is the monthly cash flow for the property over a 30-year horizon (the term of his mortgage)?
2) In which month (approximately) does the cash flow become positive?
3) Provide Jose advice on getting his property to cash flow positive sooner.