



The 1 2 3s of Income Properties  
Doug Smith, CCIM  
Swisher Commercial  
July 2007

Owning an income property can be a great way to diversify an investment portfolio that contains stocks, bonds, and other more liquid forms of investment. While real property ownership is a lot less liquid than many forms of investment, and hold periods are typically longer than for stocks and bonds, average returns can be equal or better to other forms of investment. And for those with fix-up skills and/or extra time on their hands, it can be an excellent way to build equity.

Residential Income Properties. The simplest and most widely held investment properties are small residential properties (single family homes, duplexes, tri-plexes, and four-plexes). They are easy and cost effective to finance and insure, and upkeep and repairs are straightforward to do oneself or hire out. In a decent economy, most owners are able to keep units occupied most of the time. Plan on managing and leasing units yourself, at least in the initial years, as cash flow may be slim and no one will look after your property with as much care as you will. Try to find a property that is in decent shape and that will at least break even, taking into consideration mortgage payments after a 25 to 35% down payment, property taxes, insurance, maintenance, and utilities. Properties in this category typically range between \$150,000 and 600,000 in Washtenaw County.

Larger Properties. More experienced investors or those with more funds to invest frequently own larger apartment properties (5 to 100 units or more) or office, retail, or industrial properties. First-time investors tend to prefer multi-tenant properties (where an unexpected vacancy does not mean an empty building) and ones with long-term, stable tenants. More experience investors may buy not-fully-leased or even empty properties, with a goal of buying at a discount and renovating or repositioning to add value.

Mortgages on larger properties typically carry higher interest rates and shorter terms, and insurance and other costs of operation can also be higher. Owners are more likely to have a Realtor do their leasing, and perhaps manage the property. Owners frequently partner with friends or other investor to buy properties larger than they could purchase on their own. Properties in this category tend to run from \$500,000 to many millions of dollars.

Estimating Value. There are no hard and fast rules for valuing income and investment properties, and variations in property type, location, condition, and tenancy will have a bearing on the value of any given property. But there are a few rules of thumb that may help estimate a ballpark value.

Small residential income properties are often valued according to a “gross rent multiplier” or multiple of annual rent. Often a multiplier of between 9 and 11 will be used. For example, a duplex that brings in \$20,000 a year in income may be valued at either side of \$200,000.

Larger properties tend to be valued using a “cap rate”, which applies an target return on investment to the “net income” of the property. For example, an office building may have \$200,000 in annual income, and \$80,000 in annual expenses (taxes, insurance, management, maintenance, utilities – all expenses prior to debt service). The resulting “net income” of \$120,000 is divided by a “cap rate” (or target investment value) of between 8% and 10%. When divided by a 9% cap rate, this \$120,000 net income suggests a market value of 1,333,000. Cap rates will vary according to property type, location, condition, and tenancy.

Getting Started. Owning investment properties isn't for everyone. It is much more “hands on” than stocks or bonds, even when professional management is retained. Talk to people you know who already own investment property to see what they like and don't, and what works well and what doesn't for them. Read books and articles, watch the ads, and familiarize yourself with what is on the market, what has, and what hasn't. Establish a relationship with a commercial Realtor who understands your needs and abilities, and who knows the market.

We Can Help. Here at Swisher Commercial we enjoy working with first-time buyers and seasoned investors alike. We understand the dynamics of different kinds of properties, and have a deep knowledge of the local market. Let us know what we can do to help.