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# The Siller & Cohen Report

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Siller & Cohen
*Family Wealth Advisors*

# Should You Buy? Determining the Real Value of Real Estate

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Many of our clients come to us when they are trying to decide whether to rent or buy real estate. They may be downsizing from a big house in the suburbs to an apartment in the city, considering a vacation property, or trying to help their young adult children decide whether they would be better off financially to continue renting or to buy a home, even in the circumstance where they can easily afford either choice.

Buying a home is one of the biggest investments you'll ever make, and often the decision has less to do with how well the house will perform as an investment, and more to do with whether you think your quality of life might be improved by owning it. But even where potential future appreciation in the home's value is a secondary consideration, it would be wise to evaluate the true value of the property as if it were strictly an investment. This may keep you from overpaying for the house, which in turn should also increase the likelihood that when you later sell it, you actually will make a profit.

Even eight years later, the 2008 U.S. housing market collapse remains fresh in our minds. People ask, how did it happen? There is no simple answer; there were many contributing factors. One of the contributing factors is that people often do not know how to value a home (much less a rental property), and so are challenged to make good housing purchase decisions.

People often like investing in real estate for emotional reasons. They find comfort in owning something tangible, a "real" asset. Yet, a real estate investment is subject to many of the *same* variables as any other investment, including interest rates, supply, demand, leverage, the economy, etc. Nothing is inherently a better investment; it's always about the ratio between price and value. Recall one of Warren Buffett's famous quotes: "Price is what you pay, value is what you get."[1]

As noted above, the tricky part with any investment is that while price is plainly in sight, true value is nebulous. The value of something is always an estimate. In real estate, an approach to valuing homes that is somewhat misleading when used in isolation is analyzing comparable sales to justify price, that is, judging the value of a property you are considering, and the price you're willing to pay for it, by comparing what other similar homes have recently sold for. For example, if you're thinking of purchasing a 4 bedroom home with 4,500 square feet of living space, you would research what other similar 4,500 square foot homes have recently sold for in the same neighborhood, adjusting for differences in school districts, whether a house has a pool, or a garage, etc.

While it is always a good idea to get a sense of the "deal" you're landing relative to other properties, this data point is insufficient to tell you if you're really getting a good deal on an absolute basis. If the entire neighborhood is overpriced, getting a 5% better deal than your neighbor could be the equivalent of winning the battle, but losing the war. Think of all the people who bought what they *thought* were cheap houses in 2006, only to see their entire neighborhood's property prices plummet by 30% to 40% in 2008.

**Important Metrics in Valuing Real Estate**

But how can you determine the true value of real estate? To find the best real estate deals, there are two metrics that commercial real estate investors use to help estimate the true value of a property: the price-to-rent ratio, and the price-to-income ratio.

**Price-to-Rent Ratio**

The value of an asset is the cash flow it will generate in the future, discounted back into today's dollars. What are the cash flows for real estate? Rents, of course! Thus, a key metric is the price you're paying for the property relative to the underlying potential rents the property can generate for you. You might think that if you're going to be living in the home you're buying, that rents don't matter. Nothing could be further from the truth. As Buffett has also said, "Sooner or later, valuations matter," [1] and this applies to housing as much as it applies to the stock and bond markets.

The reason the price-to-rent ratio works well is that there is no speculative element to rents. What happened in the housing bubble is that many people were willing to overpay for a home, in the hopes of finding a "greater fool" to buy that home from them at an even higher price! By instead focusing on the rental income that a property can generate, you anchor home values to something that has no speculative element. Very few people rent an apartment for the purpose of turning around and sub-leasing it to someone else at a higher rent, and pocketing the difference. Most people rent a property to live in it, not to find a greater fool. This means that rental income is a much surer predictor of value than looking at comparable sales.

Of course, there can be many factors that make real estate in a city go up in value. Taxes, job growth, geography, and weather are just a few factors that make a place more or less desirable. Remember, though, that all these factors also affect rents, which is why rents are a nice anchor to the non-speculative worth of your house.

To calculate the price-to-rent ratio, research the fair market rent for similar properties (Zillow can be very helpful here), and then subtract from the annual rent the expected landlord costs (like taxes, insurance, upkeep, etc.), to arrive at the net cash flow you would enjoy if you owned and rented the property (the "net rent"). The very general rule of thumb is: (1) buy a property at a price equal to 10 times the net rent, (2) be willing to consider a property with a price equal to 15 times net rent, and (3) sell it when the price you can sell it for reaches 20 times net rent. Of course, real estate is idiosyncratic, so you need to adjust this ratio for where you live.

The point here is to look at the valuation of your city over time to get a sense of fair valuations. Then ask your realtor to find three to five places for rent similar to what you are looking to buy and develop a specific price-to-rent ratio for the home you're considering to help you determine what price you're willing to pay. Also, if the price-to-rent ratio has been rising rapidly for a while, don't assume the prices will go up forever. Trees don't grow to the sky. Like the violent price increases we saw in the early- to mid-2000s, this can be symptomatic of a bubble.

**Price-to-Income Ratio**

The price-to-income ratio is another handy valuation metric to get a feel for home price sustainability in a community. It is not useful for evaluating a specific home, but can be very useful in determining if values in a community as a whole are low, average or high. The logic is that the income earned by the community is what pays the mortgage payment on the homes in your community, so if the price-to-income ratio for that community gets too high, the high values of the homes become unsustainable, and decreases in home values in the near future are more likely.

For example, according to the Economist magazine, in 2005 the U.S. housing market topped out at a little over four times price-to-income. At the same time, San Francisco peaked at more than 10 times price-to-income.[2] That was a clear warning signal that San Francisco housing was greatly overpriced, and would eventually suffer significant decreases in value. In fact by 2010, the San Francisco price-to-income ratio had dropped to approximately six and a half [2], and average San Francisco home prices had dropped from a high of $1,000,000 in 2005, down to $500,000 in 2009.[3]

Again, the price-to-income ratio is not very useful for valuing a specific home, but it can help predict where values in a community or city are likely to trend, and if the trend is down, the best course may be to continue to rent, and wait for prices in the overall community to drop, which in turn will mean that the prices of individual homes will also drop, allowing you to purchase at a lower price, and thus have a greater chance of making a profit.

**Other Factors Impacting Value**

In addition to price-to-rent ratio and price-to-income ratios, consider these dynamics when estimating value. Valuations are generally inversely related to interest rates; affordability has a lot to do with housing valuations. Thus, when interest rates are low (as they are now), mortgage payments are smaller, and people are willing to take out larger mortgages, and pay more for a home than they otherwise might. When this happens en mass, valuations increase. The rub is that once interest rates normalize, that is, return to earlier higher levels, prospective purchasers won't be able to qualify for the same larger mortgages, will have less to spend on a home, driving home prices down. For the prospective home purchase, there is no easy answer to this dilemma, other than to postpone a purchase, rent, and wait for valuations to come back to earth.

In conclusion, buying a home or other real estate is one of the biggest investments you'll ever make. Buying aggressively, in an expensive market, can cause you significant losses. It's worth some work and analysis to ensure that you are making a wise investment.

Sources:

[1] Warren Buffet, American Business Magnate, Investor and Philanthropist

[2] The Economist, Zillow, "Ratio of House Prices to Median Household Income"
http://www.economist.com/blogs/graphicdetail/2015/11/daily-chart-0

[3] JP's Real Estate Charts: Inflation Adjusted Housing Prices
http://www.jparsons.net/housingbubble/san_francisco.html

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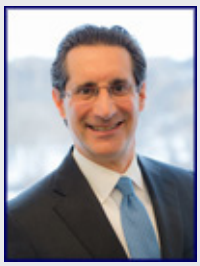

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## ABOUT SILLER & COHEN

*Siller & Cohen* is a boutique family wealth advisory firm providing financial solutions for the past twenty-eight years to institutions and high net worth individuals. We combine the detail and careful attention of a smaller firm with the deep resources of a national organization. Our team includes CPAs[1], Certified Investment Management Analysts, and attorneys.[1]

While we offer our clients the full range of planning services, our core areas of expertise include wealth transfer, investments, and business succession planning.

This is the 11th year in a row that Barron's Magazine has recognized a member of Siller & Cohen as being among the top advisors in the nation.[2]

[1] Licensed, not practicing
[2] The list was compiled by RJ Shook, Financial Industry Consultants. This is an objective ranking based on assets under management.

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