

Why rent a home when you can own?

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A number of wise and successful people have advised – “...the best thing you could do was to buy the most expensive home you could afford, since there is a limited amount of land in the world and eventually your value is bound to increase”.

If you were in many metro areas of the US in the last few years, you have seen this to be true – Phoenix has had incredible appreciation in home values. But not that long ago, there was a real estate market softening which hurt many home owners – in the short term.

So the lesson is one of “timing” and understanding of the economic and demographic backdrop in a given area. In the Phoenix valley, we’ve just seen two consecutive years of 30 – 46% price appreciation ending in November 2005 – with inventories of available homes in July 05 were at the lowest point Realtors have seen in 30 years – a feeding frenzy of buyers overbidding for homes and sellers choosing the terms and conditions.

Chicken Little in reverse.

Prices go up when there are more buyers than sellers. Prices go down when there are more sellers than buyers. Prices go up when inventories are low. Prices go down when inventories are high. And in a macroeconomic view, money moves to the superior investment and in a society that protects the right to own/pass to heirs, real property, there is an overall desire to “own a home”. Money moved quickly to valley real estate for many reasons.

Now, inventories are “normal”. Prices have stabilized; Day’s on market are within traditional boundaries. So what are the more “negative” issues now?

- Buyers are worried of “buying at the height of the market”.
- Sellers are jaded thinking they can command “over market prices”, they only need to wait longer.
- Flippers, Investors and those who bought “high” – are increasingly uncomfortable
- Someone who wants to “move up” or to another area are worried that they will not be able to find a good value in their next home.
- Someone who wants to “cash out” and lock in 04-05’s price appreciation doesn’t feel they can because they can’t find another “better” or “newer” at a fair price.
- Condo conversions are decreasing the apartment inventory and rents are rising
- The condos in those conversions are not attractively priced for either an investor or one who wants to live in one.

What are the more “positive” issues now?

- Interest rates remain historically low and favorable with no major changes on the horizon.
- Migration to the valley remains favorable due to job growth.
- Commercial and Residential development remains strong.
- There are many factors that predict a growing migration to the state whether for employment, affordable housing (as compared to other large metropolitan areas), retirement, luxury living, second “vacation” homes and investment opportunities.

But the purpose of this report is to answer the question “why rent?” – from a different point of view than a lender just wanting to give you a loan. But from a perspective of: “What is the impact on YOU”?

So why would you rent a home? Here are some possible reasons:

- There are always some apartments or rental homes available near where you want to be.
- Your employment may be seasonal or temporary, so you’re concerned about any longer term housing situation.
- Rentals often are maintained for you; so you don’t have to do much, not even mow the lawn or work on the pool.
- There is no big down payment to make (although there is a security deposit)
- The rent sometimes includes water, sewer, trash so only electric is an extra expense
- No chance of losing your shirt if the real estate markets dives and your personal situation forces a sale at the “wrong time”.
- You get nice features like pools and tennis courts
- They are often gated so you feel safer

Of course, with all the advantages come some disadvantages:

- You can’t “fix up” your apartment; no moving walls, adding bathrooms etc.
- Restrictions on pets, children, and relatives staying for extended periods.
- Rent rises with inflation
- No participation in rising real estate values

Home ownership has some distinct advantages:

- Payments are generally flat (unless you have an ARM loan)
- Your housing payment is sort of a deposit into an investment account
- There are tax benefits from carrying a home loan
- Homeowners have better credit ratings than apartment dwellers due to the regular payments on a large debt
- Pride of ownership
- As real estate increases in value, you may be able to use untapped equity in your home for further investments or catastrophes which might hobble an apartment dweller

And the disadvantages:

- Generally a large down payment is required
- Home may lose value
- Extra costs: insurance, water, sewer, repairs, maintenance, lawn, carpet, paint, etc.
- Property taxes
- Security (unless you are in a gated community, and then there is the HOA payment)

Many of these advantages and disadvantages are hard to measure; what is “pride of ownership” worth? How much is it worth to you, to live a block from downtown Scottsdale with all of the nice restaurants and other amenities which are available?

So let’s look at the hard numbers. The scenario depicted here is based on living in an apartment in Scottsdale for 3 years, compared to living in a home of similar size for 3 years, or buying a similar condominium for 3 years. In the case of ownership, I have assumed a 20% down, 6% interest and 30 year amortized loan.

For the rental, I am assuming a security deposit, a 5% per year rental rate increase, and that water and sewer is included in the rent, along with any HOA fee the complex or investor might have to pay.

I’m also assuming that the real estate market increases by 10% a year, although this is far lower than it has been recently, and even lower than the 25 year average in Scottsdale.

In the first month or so of 2006, from ARMLS data, there were 37 3-bedroom 2-bath homes with less than 1600 square feet that sold in Scottsdale. The average home was 1430 square feet, and cost \$328,000.

For condos, 10 sold, the average square footage was 1378 and the average price was \$294,000. The typical HOA fee was \$160 (though some were as high as \$241!)

3 bedroom, 2 bath apartments and rental homes: there were 21 in the same time period, averaging 1467 square feet, renting for an average of \$1241 / month.

These are average numbers for the first month and a half of 2006. It is unusual that the rentals were actually a little larger in size than the homes for sale – but these are the averages.

Let’s look at 3 years of renting:

Deposit: \$1,862
 Rent, year 1: \$14,892
 Rent, Year 2: \$15,637
 Rent, year 3: \$16,418

Total Rent: \$46,947 This is the total cost of renting an average apartment.

Repairs, upkeep, etc.: -0-

Let's now look at Buying a condo:

Down pmt: \$58,800

Closing costs: \$2,940

Loan fee: \$2,940

Total needed to buy: \$64,680

Monthly payment: (Principle, Interest, Taxes, Insurance): \$1,675 x 12 \$20,100

HOA fee: \$160 x 12 = \$1,920

Total \$22,020

Maintenance \$50/month or \$600/yr

Grand total \$22,620 / year; \$67,860 for 3 years (the costs do not escalate significantly since the lion's share is the loan which is fixed for 30 years.

Over the 3 years, though, \$9,210 of those payments would have been applied to the principal of the loan; i.e. the funds went into the house. In future years, the payment into the house (your equity) grows more quickly since, as the loan is paid off, less is owed, so the interest is reduced. I'm assuming 6% interest.

But let's see what the 10% per year appreciation has done to the value:

Year	Equity
0	\$58,500 (20% down payment)
1	$\$323,400 - \$294,000 + \$58,500 + \$2,888 = \$90,788$
2	$\$352,800 - \$294,000 + \$58,500 + \$5,954 = \$123,254$
3	$\$382,200 - \$294,000 + \$58,500 + \$9,210 = \$155,910$

So at the end of 3 years, you sell the condo for \$382,200, pay a realtor and other costs, and you come away with about \$355,466. You still owe \$225,990 on the loan, and after paying it off you walk away with \$129,476.

You originally put in a down payment of \$58,800, so you walk away with only \$70,976. BUT it would have cost you only \$47,000 if you had lived in an apartment, as opposed to the \$68,000 it cost to live in the condo.

So there's an extra \$21,000 (that's an extra \$600/month) that you had to pay to live in the condo.

BUT you still come out with a POSITIVE \$71,000.

So if you live in the apartment, it will cost you around \$50,000 over 3 years. Buy a condo, and after 3 years you can walk away with \$71,000. Which one looks better to you?

And of course, this doesn't take into consideration that interest and taxes are tax deductible effectively reducing your taxable income.

The calculations for owning a home are similar to owning a condo. Rather than the HOA fee, you get to pay for your own repairs, sewer, water, and lawn maintenance. The actual numbers depend on many factors.

Even if you cannot come up with a 20% down payment, there are other options – 90% or even 100% financing. You can get the monthly cost down by using an interest only adjustable rate mortgage. If you know you are only staying 3-5 years, there are reasonable 3/1 and 5/1 ARM loans available. In the worst case, where you would use 100% financing and an interest only loan, the numbers look like this:

Year	Equity
0	0 (100% financing)
1	$323,400 - 294,000 = 29,400$
2	$352,800 - 294,000 = \$58,800$
3	$382,200 - 294,000 = \$88,200$

Sell for \$382,200, come away with \$355,000.

Pay off the loan, clear \$88,000;

Of course, this (0% down) approach is riskier if the real estate market does not perform well. However, the payments would be \$1,440 rather than \$1675, still more than the \$1241 / month the apartment will cost.

As you can see from this, it makes lots of sense to buy condos or homes as investments and rent them out! Suppose you have a renter who is paying YOU \$1241/month to rent YOUR condo. Your loan payment is \$1675, so in effect you can buy a nice condo for (\$1675-\$1241) or around \$450 / month. (It isn't quite like that, since you have to pay the HOA and taxes, but you also get a deduction for working on this rental property)

So in conclusion, **the reasons to rent are on the more “personal” and not the financial or investment aspects.** This assumes of course that your income is enough to afford a condo or home, and in this example we used “Scottsdale” median home/condo/rent prices which are significantly higher than the rest of the valley. But home ownership is not as “out of reach” as people think. The issue is that it's difficult to put in perspective the impact of growth in the valley – (Buckeye a few years ago we considered the far west (or east LA). Yet it's only 25 miles to the Phoenix employment corridor – this is not a commute one nationally considers “unreasonable” for a large metropolitan area – and this ignores the employment opportunities in the west side itself). Ownership/Investment IS available and affordable to even those just starting out with modest incomes. There are fixer-uppers in all areas – there are condos of all conditions and areas, and there even brand new, 3br/2ba homes on both the east and west sides for under \$175,000 (3 br, 1.5 ba).

If you want a sounding board to discuss the desires and possibilities of “ownership”, send an email to MyFavoriteRealtor@cox.net or call (480) 390-7369