Investor Guide
Investment in Single Family Homes

Most often, present primary residence is a future investment home. In such a scenario, a home owner buys a home for their principal residence, lives there for some time ant then moves out to a different home either in the same town or out of town.

The move could be because the family has outgrown the size of the home; or the family has moved up the income ladder and is wanting to own a nicer home. The home owner may have lived long enough in the home to build substantial equity. He might as well qualify for a mortgage on a new home without having to sell his current home and pay-off the mortgage. In such situations, the homeowner is mostly looking to earn a rental income that will generate cash flow in excess of his mortgage payments

Many times, investors with disposable income would want to buy homes for investment purposes. In such cases, investors would seek homes that meet renters' criteria as well as potential for rental income and ease of finding tenants.

Return Expectation:
Single family homes are one of the highly leveraged investments. A 20% down payment is enough to buy an investment home. Mortgage term could be as long as 30 years. Other classes of real estate rarely offer such a high leverage. Because of generous loan funds available, competition for investment in single family homes is high. Therefore, single family homes offer moderate returns. But, for most investors, single family homes is the most easily understood investment option.

Investment Performance:
C**ash-on-cash return** is the most commonly used performance benchmark. Since the investment is highly leveraged, the investor's primary focus is to ensure that the rental income will generate cash that is in excess of all expenses associated with the investment home. The nett annual dollar income made on the property in relation to the down payment is called 'cash on cash return', often expressed as percentage.

For instance, if you a purchase a rental property with a down payment of $50,000 and your annual net income from the property is $3,000; the cash-on-cash return from the home is 6%. Property related expenses include principle and interest; property taxes; insurance; provision for vacancy loss; and budget for repairs.

Typical Cash-on-Cash Return Rates:
Positive cash flow, in other words positive cash on cash return is absolutely recommended of every investment home. Positive cash flow is possible only when the mortgage term is 30 years. In case of a 15 year mortgage term, monthly payment of principle and interest is always going to be higher than the monthly rent. We therefore strongly recommend a 30 year mortgage for your investment home. A 6% cash-on-cash return is a healthy return in the DFW area.

Older Homes

High Cash-on-Cash– Higher Repair Expenses – Little Room for Appreciation Gains

There are places where it is possible to earn a 9 or 10% cash-on-cash return. Homes in built- out towns and more desirable neighborhoods, for instance Coppell could offer a high cash-on-cash return as compared to rest of the areas in the market. However, such homes tend to be older and warrant significant reserves for maintenance as well as require professional property management. Typically homes in Coppell are 25 year old; priced at $140 per SF; average contract days on market is around 30 days; and fetch a monthly rent of $1 per SF.

Newer Homes

Lower Cash-on-Cash — Likely Lower Repair Expenses – Future Appreciation Gains

On the other hand newer towns and upcoming neighborhoods such as those in Little Elm, offer newer properties with limited need for repairs or property management. Newer homes also offer higher potential for future appreciation gains. Typically new homes in Little Elm are priced at $115 per SF; average contract days on market is around 30 days; and fetch a monthly rent of $0.86 to $0.90 per SF. Hence, cash on cash returns for new homes could be around 2 or 3%. The choice then lies between high cash-on-cash that could potentially be offset by future repairs or relatively low cash-on-cash with a potential for future appreciation gains.

Please note that this is a generic conversation and it is not our intent to tell you that all homes in Coppell are older and are in need of repair.

Downside of Older Homes for Investment:

Cash on cash return is possible only if the mortgage term is 30 years. If your investment home is already 25 year old and if you are planning to hold on to the property for the next thirty years, you should seriously question the longevity of the home, the neighborhood and the city. A time span of 55 years, from the time the home was built to the time the mortgage on the home ends, is too long to make any predictions.

It is not uncommon to see a neighborhood or a city falling out of favor for reasons beyond the control of any individual. We have a few examples right here in the DFW area. East Plano and Richardson are great examples. 15 years ago, Plano was a hot favorite, but now east Plano is little out of favor with home owners. Richardson used to be a famed telecom corridor 12 years ago. But now, it is not as desirable as it used to be. So, these two examples suggest us that neighborhoods and towns can and will go out of favor.

Repairs and maintenance is another major downside of an older home. Faced with frequent breakdowns, it is not very uncommon for tenants to call the landlord or property manager in the middle of a night. Occasional repair requests can be managed and you don't really need a property manager. But, if the repairs are too frequent, you don't want to spoil your peace of mind, so you will need a property manager. Necessity for a paid property management adds to cost and cuts net annual income from the property. Property management fee is usually around 5% of rent.

Investment Return for Older Homes Vs Not so Older Homes

Older homes in a desirable neighborhood typically fetch 9% cash on cash while relatively newer homes fetch 6% cash on cash. On a $50,000 down payment with a difference of 3% difference between an older home and a relatively newer home, you will give up $1,500 per year. But, keep in mind that a 25 to 30 year old home has most likely reached its price peak and unlikely to appreciate any further. A 10 year old home on the other hand, will most likely give you appreciation gains. So when you factor in the appreciation gains, and not have to be concerned about frequent repairs, a relatively newer home is likely to make better investment sense.

Desirable Size of an Investment Home:

Irrespective of the size of the home, and the amenities available, most renters would want to limit their monthly rental expense to $1,900. A $2,000 per month rent is a psychological threshold for most renter population. It is so because a person that could afford a rent of $2,000 might as well buy a home and pay the mortgage.

Since $2,000 monthly rent is a psychological threshold, the larger the home, the lesser will be rental rate in $/SF. The larger the home, the higher will be cost of purchase. So larger homes most likely offer lower cash-on-cash return.

Smaller homes cost more to buy in terms of $/SF. The smaller the home, the higher is the cost per SF. Since the rent is based on the size of the home, too small a home could fetch a rent that is unlikely to generate any positive cash flow. Also, renters will not like either too small a home or too large a home. Smaller homes do not meet the functional requirements while larger homes need higher maintenance.

Considering the family demographics of most renters, a home in the size range of 1800 to 2100 SF size home is ideal for investment homes.

Our Recommendation

We recommend our buyers to look for properties that offer at least 5 to 6% Cash-on-Cash return; homes no older than 10 years; in semi-mature neighborhoods; and in towns perceived as renters' preferred destinations. Considering the fact that maximum rent is in the range of $2,000, it is better to invest in a home that costs under $110 per SF. Home size should be in the range of 1800-2200SF. Purchase price should preferably under $250,000.