

Buy vs. Rent Guide



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The Buy vs. Rent Decision

One of the first things you must do is decide whether or not buying is for you. Our job is to provide you with all the information you need to make an educated decision. You can start by utilizing our resources: our rent vs. buy formulas, our rental databases, access to the multiple listing services (MLS), advice from our Housing Advisors and more. Equipped with all this information, you will be able to move forward with your plan – whether you choose to rent or buy.

Given the right circumstances, buying a home has several advantages over renting one. Your monthly housing payments go towards building your own equity instead of your landlord's and you can take advantage of substantial tax deductions. More importantly, purchasing a home can also be a solid investment with a high return on investment through property appreciation, value creation (aka "sweat equity"), rental income or instant gain if you purchase a property at a bargain price. Unless you make a cash purchase, your investment will also be leveraged, magnifying your returns by putting 100% of the home's value to work with only a 10%-20% down payment. To top it all off, if you live in the home for a minimum of two years, you eliminate capital gains taxes.

These advantages, however, may make it tempting to throw caution to the wind and over-extend oneself financially. Overpaying for a property, financing the purchase with no down payment and/or poor credit or just ignoring the fundamentals and buying the wrong property can easily negate the benefits of home ownership. That is why understanding the market and using accurate data to run the numbers is critical to making the rent vs. buy decision.

From a purely financial standpoint, the main differences between buying and renting can be broken down into the following four categories:



- 1) Initial investment
- 2) Monthly cash flow
- 3) Tax benefits
- 4) Equity

Initial investment

If you decide to buy, you will have to make a down payment and pay closing costs. There is no set formula on how much you should put down when you purchase a home. Minimizing your initial investment by making a small down payment (0%-5%) is tempting but your monthly mortgage payments will be higher and you will be less likely to rent the property at even cash flow if you decide to keep it as an investment property after you move on. Small down payments also put you at risk of finding yourself with a mortgage which is larger than the value of the property. Most of our clients purchase their properties with a 5%-20% down payment, which lowers your monthly payments and minimizes your risk while still providing significant leverage to your investment. You should also budget anywhere between 1.0-3.0% for closing costs, depending on the market where you purchase the home. Ultimately, your total cash investment will be the baseline that will determine your total return on investment (ROI). Renting has a negligible initial investment and zero risk but it also has zero upside.

Monthly cash flow

In most markets, it is still possible to purchase a property that offers the same or higher standard of living as a rental -- for similar monthly payments. When you purchase a home, your monthly expenses will consist of your mortgage payment (principal and interest), property taxes and condominium assessments (if applicable). Condo assessments pay for maintenance and upkeep of the building and common areas and usually include many utilities you would pay for if you rented (e.g. heat, water, cable, etc.).

Tax advantages †

When you buy a home and live there as your primary residence, Uncle Sam lets you deduct the interest and property taxes from your ordinary income. If you decide to rent out your property instead of selling it, the tax benefits change. In the eyes of the IRS, your property now becomes an income-generating asset or “business”. The bad news is that the rent you receive from your tenant becomes taxable income; the good news is that you can depreciate the property and deduct your condo assessments, interest and property tax. The IRS lets you depreciate the value of the property – not the land – over 27.5 years. The net result of the income from rent and all the deductions is usually a small accounting loss, which you may or may not be able to offset against other sources of income.

Equity

The main difference between buying and renting is that buying a home gives you the ability to create equity. Equity is created in several ways: 1) your monthly payments paying down the mortgage 2) property value appreciation 3) value creation by improving the condition and appeal of the property 4) instant gain if you purchase a property at a bargain price and 5) rental income if you keep the home as an investment property instead of selling it. Initially, the bulk of your mortgage payment will go towards paying interest and very little will go towards principal. Therefore, most of the equity creation will come from the other four sources. If you choose an interest only mortgage, your payments will only cover the interest on the loan and will not pay down the mortgage.



Appreciation is impossible to predict and depends on housing supply and demand at a given price in the market in which you are looking. Interest rates are perhaps the biggest macroeconomic drivers of property values. Lower rates usually feed demand because housing becomes more affordable, and vice versa. Higher interest rates will typically slow down home value appreciation in the short term but the effect over time is more complex. As interest rates increase and financing a home purchase becomes less affordable, building costs also increase and dampen housing supply. High interest rates are also typically accompanied by higher inflation, driving investors to hard assets such as real estate and strengthening demand. More inflation will also drive up rents, so an investment property will give you an “inflation-proof” source of income.

One of the most important things to keep in mind is that since you will most likely get a mortgage to finance 80% - 95% of the purchase price, your cash on cash return on investment is a multiple of the actual property appreciation rate. For example, if you put 5% down, then every 1% in property value appreciation results in a 20% increase in your cash on cash return. The downside, however, is that leverage actually works against you if property values go down. High leverage will also make your monthly payments higher, reducing the likelihood of renting out your property at even cash flow.

When you decide to sell, you need to take into account the costs of selling associated with exiting your investment. A seller’s closing costs range between 1.00-3.00% of the sales price, depending on the market. Furthermore, if you employ a broker to help you sell your property, you will have to pay a commission to your listing agent and another one to the agent that produces the buyer. Total commission is usually between 4.00%-6.00%.

Last but not least, remember that if you live in your property for at least two of the last five years before you sell, you don’t have to pay capital gain taxes.

† Consult competent legal and/or accounting advice for all tax related information.



Case Study: Rent vs. Buy

The following case study walks you through the analysis we would perform for a client who is deciding between buying and renting. Please keep in mind that the numbers are hypothetical. Nonetheless, the approach and financial analysis is the same.

Initial investment analysis and assumptions

- You are evaluating two options:
 - 1) Renting an apartment for \$1,600 / month.
 - 2) Purchasing a condo for \$250,000 with a 10% down payment (\$25,000), a second mortgage for 10% (\$25,000) and a principal mortgage for 80% of the purchase price (\$200,000).
- A 5-1 ARM interest only loan with a 6.00% rate for the primary mortgage and a 7.50% rate for the second mortgage.
- Annual property taxes for the condo are about 1.50% of the purchase price (\$313 / month or \$3,750 / year).
- Condo assessments are \$250 / month and include heat, water and cable.
- Closing costs are about 1.5% of the purchase price (\$3,750).

Monthly cash flow analysis

While you live in the property

Renting		Buying	
Rent	\$1,600	Interest for primary mortgage	\$1,000
Heat	\$100	Interest for second mortgage	\$156
Cable	\$50	Principal	\$0
		Property taxes	\$313
		Condo assessments	\$250
Total monthly cash flow	\$1,750	Total monthly cash flow	\$1,819

Conclusion: Total monthly cash flow is comparable for buying and renting.

If you move after two years and decide to rent out your property instead of selling it:

Renting	Buying	
	Rental Income*	\$1,800
	Interest for primary mortgage	\$1,000
	Interest for second mortgage	\$156
	Property taxes	\$313
	Condo assessments	\$250
	Property management (3% of rents)	\$54
	Broker commissions **	\$75
	Maintenance, repairs and reserves	\$50
	<i>Total operating expenses</i>	<i>\$1,898</i>
	Total monthly cash flow	(\$98)

Conclusion: Rental income will finance 95% of your monthly expenses.

* The idea is that you purchase a place that can be rented out cash flow positive or break even. By analyzing the rental market with your housing advisor (before you buy), you will be able to compare and price your property vs. the other rental options that are available in the market. Keep in mind your property will be rented out years after you purchase it, when rents will most likely be higher.

** The standard fee to procure a renter is one month's rent. The idea is that we rent the property out to a tenant that will stay in the property for at least two years. This way, the commission expense is spread out over 24 months.

Tax benefits analysis †

While you live in the property:

Renting		Purchasing	
		Interest for primary mortgage	\$1,000
		Interest for second mortgage	\$156
		Property taxes	\$313
		Total monthly deductions	\$1,469
		Total annual deductions	\$17,628
		Your tax bracket	28%
Total tax savings	\$0	Total annual tax savings	\$4,936*

Conclusion: Buying will save you a substantial amount of money when it comes to paying taxes.

* Equivalent to \$411/month.

If you move after two years and decide to rent out your property instead of selling it:

Renting		Purchasing	
		Rental income	\$1,800
		Interest for primary mortgage	\$1,000
		Interest for second mortgage	\$156
		Property taxes	\$313
		Condo assessments	\$250
		Monthly depreciation	\$606
		Commissions and management	\$129
		Total monthly deductions	\$2,325
		Accounting loss	(\$654)
		Total annual deductions	\$7,848
		Your tax bracket	28%
Total tax savings	\$0	Total annual tax savings	\$2,197

Conclusion: Your investment will continue to save you money in taxes.

* Equivalent to \$183/month.

† Consult competent legal and/or accounting advice for all tax related information.

Equity analysis

Two years after purchasing the property:

Renting		Purchasing	
		Property Value*	\$ 276,235
		Balance Primary Mortgage**	\$ 200,000
		Balance Second Mortgage**	\$ 25,000
		Exit Costs***	\$ 17,955
		Buyer Agent (2.50 %)	\$ 6,906
		Listing Agent (2.50 %)	\$ 6,906
		Closing costs (1.50 %)	\$ 4,144
		Initial Investment	\$ 28,750
Net equity	\$0	Net Equity	\$ 33,280
		Cash on Cash (ROI)	15.8%

Five years after purchasing the property:

Renting		Purchasing	
		Property Value*	\$ 320,840
		Balance Primary Mortgage**	\$ 200,000
		Balance Second Mortgage**	\$ 25,000
		Exit Costs	\$ 20,768
		Buyer Agent (2.50 %)	\$ 7,988
		Listing Agent (2.50 %)	\$ 7,988
		Closing costs (1.50 %)	\$ 4,793
		Initial Investment	\$ 28,750
Net equity	\$0	Net Equity	\$ 75,072
		Cash on Cash (ROI)	161.1%

Conclusion: Though it is impossible to predict appreciation rates, buying allows you to participate in equity creation.

* Assumes a 5% appreciation per year. Consult your agent to find out about appreciation in your area.

** Recall we took on an interest only mortgage to minimize payments. Hence, the mortgage does not go down.

Month	Year 1 --> 1	Year 1 Total	Year 2 --> 13	Year 2 Total	Year 3 --> 25	Year 3 Total	Year 4 --> 37	Year 4 Total	Year 5 --> 49	Year 5 Total
FINANCING DETAILS										
Purchase Price	\$ 250,000									
Down Payment	10%									
Closing costs	\$ 3,750									
Total Cash Investment	\$ (28,750)									
Primary Mortgage										
Term (Years)	30									
Interest Only?	yes									
Interest Rate	6.00%		6.00%		6.00%		6.00%		6.00%	
Second Mortgage (interest only)										
Second Mortgage Interest Rate	7.50%									
Interest Payment	\$ 156									
CASH FLOW BENEFITS FROM BUYING										
BUYING cash flow										
Rent Income	\$ 0	\$ 0	\$ 0	\$ 0	\$ 1,800	\$ 21,600	\$ 1,900	\$ 22,800	\$ 2,000	\$ 24,000
Primary Mortgage Payment	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000
Principal	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Interest	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000	\$ 1,000	\$ 12,000
Second Mortgage Payment	\$ 156	\$ 1,875	\$ 156	\$ 1,875	\$ 156	\$ 1,875	\$ 156	\$ 1,875	\$ 156	\$ 1,875
Property Taxes (1)	1.50%	\$ 313	\$ 3,750	\$ 322	\$ 3,863	\$ 332	\$ 3,978	\$ 341	\$ 4,098	\$ 343
Assessment (1)		\$ 250	\$ 3,000	\$ 258	\$ 3,090	\$ 265	\$ 3,183	\$ 273	\$ 3,278	\$ 281
Primary Mortgage Insurance		\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Property Management (2)	3.00%	\$ 0	\$ 0	\$ 0	\$ 0	\$ 54	\$ 648	\$ 57	\$ 684	\$ 60
Commissions (3)		\$ 0	\$ 0	\$ 0	\$ 0	\$ 150	\$ 1,800	\$ 158	\$ 1,900	\$ 167
Maintenance, repairs and misc. (1)		\$ 100	\$ 1,200	\$ 103	\$ 1,236	\$ 106	\$ 1,273	\$ 109	\$ 1,311	\$ 113
Total outflows		\$ 1,819	\$ 21,825	\$ 1,839	\$ 22,064	\$ 2,063	\$ 24,757	\$ 2,096	\$ 25,146	\$ 2,119
Monthly Cash Flow		(\$ 1,819)	(\$ 21,825)	(\$ 1,839)	(\$ 22,064)	(\$ 263)	(\$ 3,157)	(\$ 196)	(\$ 2,346)	(\$ 119)
RENTING cash flow										
Rent	\$ 1,600	\$ 19,200	\$ 1,700	\$ 20,400	\$ 1,800	\$ 21,600	\$ 1,900	\$ 22,800	\$ 2,000	\$ 24,000
Parking - Extra expense vs. buying	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Utilities - Extra expense vs. buying	\$ 150	\$ 1,800	\$ 155	\$ 1,854	\$ 159	\$ 1,910	\$ 164	\$ 1,967	\$ 169	\$ 2,026
Heat (1)	\$ 100	\$ 1,200	\$ 103	\$ 1,236	\$ 106	\$ 1,273	\$ 109	\$ 1,311	\$ 113	\$ 1,351
Water (1)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Gas (1)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Cable (1)	\$ 50	\$ 600	\$ 52	\$ 618	\$ 53	\$ 637	\$ 55	\$ 666	\$ 56	\$ 675
Internet (1)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Other (1)	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Monthly Cash Flow		(\$ 1,750)	(\$ 21,000)	(\$ 1,855)	(\$ 22,254)	(\$ 1,959)	(\$ 23,510)	(\$ 2,064)	(\$ 24,767)	(\$ 2,169)
Cash flow savings from buying		(\$ 69)	(\$ 825)	\$ 16	\$ 191	\$ 1,696	\$ 20,352	\$ 1,868	\$ 22,421	\$ 2,049
Cash on cash ROI			-2.87%		0.66%		70.79%		77.99%	
TAX BENEFITS FROM BUYING										
Effective Tax Rate	No 28%		No 28%		Yes 28%		Yes 33%		Yes 33%	
Rent out?	No		No		Yes		Yes		Yes	
Gross Income	\$ -	\$ -	\$ -	\$ -	\$ 1,800	\$ 21,600	\$ 1,900	\$ 22,800	\$ 2,000	\$ 24,000
Total Deductions	\$ 1,469	\$ 17,625	\$ 1,478	\$ 17,738	\$ 2,359	\$ 30,109	\$ 2,377	\$ 30,424	\$ 2,386	\$ 30,634
Interest	\$ 1,156	\$ 13,875	\$ 1,156	\$ 13,875	\$ 1,156	\$ 13,875	\$ 1,156	\$ 13,875	\$ 1,156	\$ 13,875
Property Taxes	\$ 313	\$ 3,750	\$ 322	\$ 3,863	\$ 332	\$ 3,978	\$ 341	\$ 4,098	\$ 343	\$ 4,110
Assessment	\$ -	\$ -	\$ -	\$ -	\$ 265	\$ 3,183	\$ 273	\$ 3,278	\$ 281	\$ 3,377
Depreciation	\$ -	\$ -	\$ -	\$ -	\$ 606	\$ 7,273	\$ 606	\$ 7,273	\$ 606	\$ 7,273
Commissions / Property Management	\$ -	\$ -	\$ -	\$ -	\$ 150	\$ 1,800	\$ 158	\$ 1,900	\$ 167	\$ 2,000
Maintenance, repairs and misc.	\$ 100	\$ 1,200	\$ 103	\$ 1,236	\$ 106	\$ 1,273	\$ 109	\$ 1,311	\$ 113	\$ 1,351
Accounting Income	\$ (1,469)	\$ (17,625)	\$ (1,478)	\$ (17,738)	\$ (559)	\$ (8,359)	\$ (477)	\$ (5,724)	\$ (386)	\$ (4,634)
Tax Shields	\$ 411	\$ 4,935	\$ 414	\$ 4,967	\$ 157	\$ 2,340	\$ 157	\$ 1,889	\$ 127	\$ 1,529
Cash on cash ROI		17.17%		17.27%		8.14%		6.57%		5.32%
EQUITY GROWTH FROM BUYING										
Annual Appreciation	5.00%		5.00%		5.00%		5.00%		5.00%	
Property Value	\$ 250,000	\$ 262,790	\$ 262,790	\$ 276,235	\$ 276,235	\$ 290,368	\$ 290,368	\$ 305,224	\$ 305,224	\$ 320,840
Balance Primary Mortgage	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Balance Second Mortgage	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000	\$ 25,000
Exit Costs	\$ 14,375	\$ 15,110	\$ 15,110	\$ 15,884	\$ 15,884	\$ 16,627	\$ 16,696	\$ 17,478	\$ 17,550	\$ 18,372
Buyer Agent	2.50%	\$ 6,250	\$ 6,570	\$ 6,806	\$ 6,806	\$ 7,229	\$ 7,289	\$ 7,599	\$ 7,631	\$ 7,988
Listing Agent	1.75%	\$ 4,375	\$ 4,599	\$ 4,599	\$ 4,834	\$ 4,834	\$ 5,081	\$ 5,319	\$ 5,341	\$ 5,591
Closing costs	150%	\$ 3,750	\$ 3,942	\$ 3,942	\$ 4,144	\$ 4,144	\$ 4,337	\$ 4,569	\$ 4,578	\$ 4,793
Net Equity	\$ 10,625	\$ 22,680	\$ 22,680	\$ 35,352	\$ 35,352	\$ 47,536	\$ 48,672	\$ 61,480	\$ 62,673	\$ 76,137
Year over year gain / loss		\$ (6,070)		\$ 12,672		\$ 12,185		\$ 12,808		\$ 13,463
Year over year ROI		-21.11%		44.08%		42.38%		48.50%		50.98%
Cumulative gain / loss		\$ (18,125)	\$ (6,070)	\$ 6,602	\$ 6,602	\$ 18,786	\$ 19,922	\$ 32,730	\$ 33,923	\$ 47,387
Cumulative cash on cash ROI			-21.11%		22.96%		65.34%		113.84%	
Eligible for tax shields? (4)	Yes		Yes		Yes		Yes		Yes	
Year over year savings (total)		-\$ 1,960		\$ 17,829		\$ 34,877		\$ 37,117		\$ 39,586
Year over year ROI		-6.82%		62.01%		121.31%		129.10%		137.69%

Screenshot of Rent vs. Buy Pro Forma

Conclusion

Buying requires a significant investment and willingness to assume risk, yielding significant tax benefits and allowing you to grow your equity. Renting is a “cleaner” option – you move in when you are ready, and can move out when your lease expires. Unless you are a tenant at will, keep in mind breaking a lease carries financial penalties.

If you think buying might be an option for you, we will happily walk you through the entire process and provide you with all the information you need to make an informed decision. Take a moment to review the following table to see where you are leaning at this point. Items in the green boxes are advantages and articles in the red boxes are disadvantages.

Renting	Buying
<p>Advantages</p> <p>No downside: Not gaining equity, but not losing it either.</p> <p>Easy exit: When the lease is up, you can just move.</p> <p>Fewer worries: There is generally less work in maintaining a rental.</p> <p>Minimal "up-front" cash.</p>	<p>Disadvantages</p> <p>There is risk: Property value may go up, down, or stay the same.</p> <p>Exit costs: If you want to move and you don't want to keep the property as an investment property, it takes time and money to sell it.</p> <p>Maintenance: Work needs to be done by you --or paid for by you.</p> <p>Initial investment: The down payment and closing costs.</p>
<p>Disadvantages</p> <p>No upside: No matter what happens with the value of the home, you will never gain equity - your landlord will.</p> <p>Cookie cutter home: Limited -- or no ability to personalize your living quarters.</p> <p>No tax advantages: Your landlord gets any and all tax breaks available.</p>	<p>Advantages</p> <p>Equity creation: The ability to participate in equity creation as the property appreciates and the mortgage balance decreases.</p> <p>Home sweet home: You can remodel and redecorate home to match your style.</p> <p>Tax advantages: Deduct interest and property taxes from ordinary income. †</p>

† Consult competent legal and/or accounting advice for all tax related information.



Disclosures

***Consult competent legal and/or accounting advice for all tax related information ***

- Investing in real estate may be appropriate for you if you are willing to accept the risks and uncertainties of investing in the real estate market.
- Real estate is a cyclical business, highly sensitive to general and local economic developments and characterized by intense competition and periodic overbuilding. Real estate income and values may also be greatly affected by demographic trends, such as population shifts or changing tastes and values. Government actions, such as tax increases, zoning law changes or environmental regulations, may also have a major impact on real estate markets. Changing interest rates and credit quality requirements will also affect the cash flow of real estate assets and their ability to meet capital needs.
- Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized.
- Owning and operating real estate requires specialized management skills and bears management and operating expenses.
- The risks of investing in this project may be intensified because it is non-diversified.

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