

To Lease or Not to Lease

This is a question both buyers and sellers ask. Would it be better to buy a home or lease one? Would it be better to sell my home or lease it out? And as much as we wish big questions like that were easy to answer, they are not.

But that doesn't keep us from trying to figure it out. The first answer is "It depends." Not very satisfying. But the best decision will rely completely on the specific circumstances facing the individual buyer or seller.

My job here is to lay out many, if not all, of the considerations for both buyers and sellers, so you can take that information, put it into your individual circumstances, and come up with a decision that fits your goals and your needs.

I am not here to convince anyone to do anything. As with all my reports and analysis, my goal is to inform you, not to persuade you.

For Both Buyers and Sellers – *the value of the property.*

The question that represents common ground for both buyers and sellers is what the value of the property in question is. **What will it rent for? And, what will it sell for?**

Figuring this out requires that you have an accurate view of the home's value. This is something very few people can do without the help of an experienced Realtor. **You cannot trust Zillow, Trulia, or other valuing sites** for this, nor can you pick the house down the street and take the neighbor's word of mouth for what it sold for. Valuation is not an easy formula, and requires the skills of someone who does it frequently and accurately. **The good news is that a capable and reliable realtor will do this for you for free. I will.**

Back to our example. Let's say a roughly 3,000 sqft, averagely upgraded, home in Vista Del Verde (a newer community in Yorba Linda, CA), would sell for \$830,000 and would rent for \$4,700/mo.

Every month a home owner pays out cash directly related to that home that he sees no return for. He sees no return for the interest on his mortgage. He sees no return for what he spends on taxes. And, he sees no return for what he spends on repairs, insurances, HOA, and the like.

If these monthly costs are significantly greater than what it would cost to rent the house then, it is easy to conclude that it makes more sense to rent the property than to buy it. Likewise, if the cost to rent the home far exceeds those monthly out of pocket costs home owners incur, then buying becomes much more appealing.

From a seller's point of view, if his monthly costs exceed what he could get for renting the property then the decision to sell rather than lease becomes much easier. But this is not all that concerns the seller. We'll talk more about that later.

The information should be considered reliable but not guaranteed.

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Let's look at our example:

Value of Home	Rental Rate
830,000	4,700

Mortgage	80.00%	664,000
Mortgage Rate	4.50%	29,880
Mort % per Mo		2,490
tax rate	1.08%	8,964
Tax/mo		747
Total Interest/Taxes		3,237
Less Tax write-off	35.00%	2,104.05
Home Warrantee	700	58
Home Fire Etc Ins	2,000	167
Repairs	3,000	250

Ownership Costs	2,579.05
Ownership Advantage	2,120.95 per month

We are assuming that our buyer could put 20% down and get a loan at 4.5%.

Under this scenario, it is much cheaper to own than to rent. This won't always be the case. The situation varies from neighborhood to neighborhood and changes over time. So, a prudent buyer will need to do this research carefully – with the help of a good realtor – as will a prudent seller. (If you would like this spreadsheet, let me know and I'll send you a copy.)

Buyer Specific – What other concerns are there specific to buyers?

There are factors, other than purely financial, that impact the decision on whether to buy or lease.

The Pride of Ownership Factor. Some people feel that home ownership (rather than leasing) is connected to their private sense of prosperity. That is, some people feel that leasing a home represents a certain “less-than” position than home ownership.

Home ownership, for some, feels like a right, an American right. So, some people will look at leasing as a kind of failure.

On the other hand, some people love the idea of living in a home and not having to worry about all the extra cares associated with homeownership, like repairs, the HOA, the insurances etc.

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For those that fit into the first group, they may be willing to pay more for ownership, just to enjoy the right of property ownership. For others, they may be willing to pay more to lease just to have less to worry about at the end of the day.

The important thing is to be acutely aware of which of these two groups you fit into.

“It’s the Perfect Time To Buy” Factor. This is the idea that it is a great time to buy now, and that by not buying you will miss out. Maybe it is, maybe it isn’t. That said, you can probably step out of your house, throw a rock and hit a Realtor who will say without hesitation “Now is the perfect time to buy!” no matter what the actual conditions are in the market.

Whether it is the perfect time to buy or not depends a great deal on your individual situation.

What are the conditions in the market as of the last half of 2011?

(This part I’m going to have to return to and occasionally update.)

- Most analysts feel, and I agree, **that we are a long way from seeing the market turn around.** If it is going to “turn around” at all, it won’t be for seven years, maybe ten. My feeling, in fact, is that it may be that we should not be waiting for the market to come back or turn around. We may be facing a “new normal”. I think many people are waiting to hear the news that it’s over. The recession is over. I have a feeling that rather than seeing us break free from it, we will live it more or less for the next twenty years. If things improve, they will improve very slowly, not more than a couple of percent improvement a year.
- **Even if we see jobs come back** – and we should not expect to see that for a while, (I’m guessing four years, best case) – real estate will follow that by a couple of years because once people are back working, they will need to be working securely for a while before down payments, credit repair, and work histories can be established.
- **Right now the whole world is broke.** No one is thriving. The order of the day for both big business and government is to try to stem the bankruptcy tide. All efforts right now are focused on trying to keep the world economy from crashing altogether. **Recovery isn’t even on the table. Survival is what we’re hoping for.**
- **We are now selling at 2002, 2003 prices.** That’s roughly ten years. The first five was up, and the last five has been down. If we were to make an about face right this second, and **right now** start hearing that the economic news was nothing but positive, do you think it would be reasonable that we could be back to the peak in five years? I don’t. The fact is we are not going to hear that kind of good news for some time. If it took five years to get here, we can’t possibly get back in less than five. And I find it entirely unlikely that even in seven could we expect to see what most call the return of their home’s value.

The two big concerns for buyers are 1) is the house I’m thinking about buying today going to be worth less a couple of years from now? And 2) interest rates.

The answer to question one will be in most cases, I think, yes. Or at best the home will be worth roughly what is worth today. That’s the best case scenario for the next couple of years minimum.

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The issue with **interest rates** is that while they are very low today, and that *is* very good for buyers, **the reason they are low is that the overall economy is terrible**. Low mortgage interest rates are a sign of a suffering economy. When all other investments are so unattractive that people are flocking to mortgage backed securities and the like, interest rates stay low for buyers. So, it is a double edged sword.

Nevertheless, people are buying and selling homes. Your specific situation may combine with the factors above and give you good reason to think now is the time to buy or it may not. Do a lot of research, gather all your best advisors together including a knowledgeable Realtor, as well as your financial and tax advisor, and do the hard work to see if this is the right time to buy a home.

Above all else, remember that **the emotional health of your family and marriage far outweighs all other concerns**. Be sure that whether you buy or lease, that decision serves the best interests of the most important things in your life. Now is NOT the time to put yourself under more financial pressure. Put yourself under less financial pressure. That may mean buying. That may mean leasing. That may mean staying put. Think hard about that.

Seller Specific – *What other concerns are there specific to sellers?*

There is a lot more to consider for sellers than for buyers. It gets complicated.

First, let’s take another look at the scenario above, but let’s throw in some other numbers:

	COST of Home	Rental Rate
	1,250,000	4,700
Mortgage	90.00%	1,125,000
Mortgage Rate	5.50%	61,875
Mort % per Mo		5,156
tax rate	1.08%	13,500
tax\mo		1,125
Total Interest/Taxes		6,281
Less Tax write-off	0.00%	6,281.25
Home Warrantee	700	58
Home Fire Etc Ins	2,000	167
Repairs	3,000	250
Ownership Costs		6,756.25
Ownership Advantage		-2,056.25 per month

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At the top of the report we put a current market value of the house at \$830,000. **In this set of numbers we are not talking about the value of the home, but its cost.**

Furthermore, a home owner is not writing off mortgage interest and tax payments on a rental property. In the seller scenario, **the seller takes the amount made in rent payments and deducts mortgage interest, taxes, HOA, insurances, repairs etc., in order to calculate the net income that they will have to pay federal and state taxes on.**

Here, the story is even worse than that. It is common these days that home owners are paying a mortgage on a home that is more than what the home would sell for. Many home owners are “under water”. You can see that the numbers in this scenario are much less encouraging. The ownership costs are nearly the rental rate. Should repairs be more than the above budget, a home owner could be out of pocket.

Furthermore, **vacancy rate** makes the above scenario impossible. We’ll go over that later. Let’s just say that if the above numbers fit a home owner’s situation, that home owner should get advice about **the possible benefits of short selling** the home rather than waiting for the market to turn around (see the market analysis under the section for Buyer’s concerns).

For the moment, let’s look at some more optimistic numbers:

	COST of Home	Rental Rate
	1,250,000	4,700
Mortgage	70.00%	875,000
Mortgage Rate	5.50%	48,125
Mort % per Mo		4,010
tax rate	1.08%	13,500
tax\mo		1,125
Total Interest/Taxes		5,135
Less Tax write-off	35.00%	3,338.02
Home Warrantee	700	58
Home Fire Etc Ins	2,000	167
Repairs	3,000	250
Ownership Costs	3,813.02	
Ownership Advantage	886.98	per month

Under this scenario a home that cost its owner \$1.25M to buy, and who owes \$875,000 on the mortgage, could, in a given month, expect to pocket almost \$890/mo by leasing the home, if all the other numbers remained accurate. Still, he’s under water, owing more than the home is worth.

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This is where a seller might hope that he could rent out his home, make a little money and wait for the market to return in order for him to sell without having to face a short sale. He would have to sell for around \$932,000 to break even considering his \$875K mortgage and the roughly 6.25% sales costs assuming he could get a realtor to work for 5% commissions (which is fairly common these days). That \$932K represents a 12.3% increase in the current market value of \$830K. That is a huge increase. Based on what we've said about market conditions above under Buyer's Concerns, that is a minimum 4 to 5 year wait, and maybe longer. That combined with the vacancy rate issues mentioned below make this a very hard road to pursue, but by all means doable.

The question I would have is why not just stay put? Unless the seller was willing to move out and rent a much cheaper home (easier for some than for others), becoming a landlord seems like a lot of work for negligible returns.

Let's look at some optimistic numbers:

	COST of Home	Rental Rate
	1,250,000	4,700
Mortgage	40.00%	500,000
Mortgage Rate	5.50%	27,500
Mort % per Mo		2,292
tax rate	1.08%	13,500
tax\mo		1,125
Total Interest/Taxes		3,417
Less Tax write-off	0.00%	3,416.67
Home Warrantee	700	58
Home Fire Etc Ins	2,000	167
Repairs	3,000	250
Ownership Costs		3,891.67
Ownership Advantage		808.33 per month

In this scenario the home owner has lots of equity in the home. He's carrying a mortgage of just \$500K. Here, he stands to pocket just over \$800/mo or around \$9,700/yr (less taxes). If the seller were to sell the home now at the market rate of \$830,000, after costs they could expect to net out at around \$278,000.

Before we talk about that, let's look at that \$9,700.

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Vacancy Rate. This bad boy should be the chief concern of any homeowner that wants to think about leasing rather than selling their home. **You can expect between one and two months vacancy** to get your first tenants in **if the home goes on the market for the correct rental rate.**

In your first year, you should count on not 12 month's rent coming in but no more than 11, and probably just 10 months.

So, in the above example, if the home owner, on a good month can take in \$800/mo extra, but then loses 2 months' rent (\$1,600) while paying 12 months of home ownership costs of \$3,891.67/mo, the overall yearly gain is just \$300. (Think how fast this amount can be eaten up quickly with a water break, a dead furnace, or a leaking pool, so get all those home warranties you think you'll never need.)

With three month's vacancy the gain turns to a loss of \$4,400. So you can see that **vacancy kills.**

And because vacancy kills – Pricing is EVERYTHING. If you overprice the home in a rental scenario, you risk losing a lot.

Let's say you try renting your home for \$5,000 instead of \$4,700 because you'd like that extra \$300/mo cushion. If you can rent it in 30 days at \$4,700, based on the numbers above, you could have a net gain of about \$5,000 for the year. **But if you have to wait 90 days** to get \$5,000 (not at all an unreasonable possibility), then you will have had **a net loss of just over \$1,700** for the year, and will have lost **\$6,700** from what you could have made if you just started at \$4,700 to start with.

And, in all likelihood instead of getting it rented in 90 days for the \$5,000, you will be forced to then lower the price to the appropriate market rate of \$4,700, having now come down to **a yearly net loss of just over \$4,400,** and **taking home \$9,400 less** than if you would have started at the \$4,700 mark.

Do Not Count On that perfect tenant that keeps your home in perfect condition, and stays for several years. Be very conservative with your estimates. It is better to get a good surprise than a bad one. Expect that you will need to trade tenants out every year. Even if you get lucky with a tenant who stays for two years, the next one may only stay for six months.

Upkeep on a Rental Property. Renting a home out is not for the faint of heart. You will get late night calls that the toilet is leaking, and hot summer day calls that the air conditioning is out.

There is a section above, under Buyer's concerns, that discusses the current market. **If you are planning to rent until home values return, you are going to be in it for the long haul. Probably seven to ten years.**

If you are not up for that kind of back and forth, think hard about whether you are landlord material.

Currently property management companies are charging between 7% and 10% to keep tenants in your property and help when they leave and new tenants come in. You may be able to barter that 7% down, but don't expect to go much lower than 6%.

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The Investment Angle. Let's look again at that scenario –

Disclaimer. I'm not a financial guy. I'm great at valuation of property, but I'm not a loan guy, a tax guy, or a finance guy. So, take these numbers with a grain of salt and check them with those you rely on. I believe they are accurate, but again, I'm not the expert in this arena.

Let's look at our example again:

	COST of Home	Rental Rate
	1,250,000	4,700
Mortgage	40.00%	500,000
Mortgage Rate	5.50%	27,500
Mort % per Mo		2,292
tax rate	1.08%	13,500
tax\mo		1,125
Total Interest/Taxes		3,417
Less Tax write-off	0.00%	3,416.67
Home Warrantee	700	58
Home Fire Etc Ins	2,000	167
Repairs	3,000	250
Ownership Costs		3,891.67
Ownership Advantage		808.33 per month

The sale of this home at the market rate of \$830K would net the seller roughly \$278,000.

If you rented out your home and were able to keep vacancy down to a month and a half a year (you'd be lucky to do that), and all the other costs above were accurate, you could bring home an extra \$2,650 per year. We'll say we have to do this for seven years, so that's a total of about \$18,550. Let's say you put all that toward your mortgage, so now your mortgage is just \$480,000. (I'm rounding these numbers a bit to make them easier to look at.)

Let's say that things so well and **that in seven years** you are able to sell the home for \$1,050,000. You would net about \$504,375 considering the reduction in your mortgage and the pay off ect. That's a great number. **Keep in mind this is a best-case scenario.**

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FINALLY, if you sold the home right now and took the \$278,000, what could you expect to get for that investment after seven years? At 3.3% compounded in seven years you would have a return of about \$348,937. Way up at 10% you'd be earning \$541,743. That makes the \$504K from taking the rental route look like a competitive strategy.

So, given –

1. Super low vacancy
2. Super low home repair costs
3. a significant amount of equity in the home (minimizing the monthly costs of home ownership)
4. the willingness and energy to work as a landlord for several years (right now I would say about seven years)
5. And, the riskiest assumption of all, that the market will have values up over 26.5% seven years from now

Now at last –

THE SCENARIO BECOMES POTENTIALLY WORKABLE AND PROFITABLE.

Your specific scenario will vary.

To Conclude – *What's the theme we've mentioned over and over?*

Get advice. Do the math. Consider the health of your family, and your realistic ability to pull off the strategy you select.

Whether it is better to buy or lease or sell or lease depends on your situation. I've put down some things for you to add into your thoughts.

Be **realistically optimistic**. I've preached this in my blog. Being realistically optimistic does not mean disregarding the bad news of the economy. It means weighing it, evaluating it, and acting wisely. If things are not going to go better for the economy at large, at least be sure to act wisely so things go better for you. We can take bad news. In fact, we need to hear the truth. What we do with that truth makes all the difference. Those that bury their head in the sand won't do well. We take the circumstances that are given to us, and make the very best of them. That is realistic optimism. We can survive and even thrive in this economy if we will face it, and make good choices.

Thanks for taking a look at this. I hope it was helpful.



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You can keep up with property values and trends at –

<http://tomkoel.com/vistadelverde>

or on your **smart phone** by pointing your phone at this –

(You'll need a QR reader app. They're free)



Here's how you find us!!

You can always find Videos on various property listings, old and current, plus videos on local vendors as well as all our monthly videos for Vista Del Verde here:

<http://tomkoel.com/vistadelverde>

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<http://tomkoel.com/realestatelistings>

<http://tomkoel.com/yorbalindalocals> - on the **US FOLKS** page.

Also, you may want to check out our forum page for forums on the various communities throughout Yorba Linda at –

<http://tomkoel.com/phpBB3> the **SPEAK UP** page.

AND it's all up on the **YouTube** channel at <http://YouTube.com/tomkoel>

(Did I mention we're on **Facebook**, too? At <http://facebook.com/tom.koel>)

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And, check in on our video **Blog** at <http://tomkoel.wordpress.com>

Finally, if you're a property junky, check out this home! You'll get a kick out of the video!

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