White Paper

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The Costs and Benefits of Purchasing a Second Home

A vacation home can provide a welcome escape for you and your family, but it's wise to examine the financial viability of the investment before you buy

Many people reach a point in life where they consider purchasing a second home. They might be preparing to retire in another part of the country, hoping that the property they purchase today will become a good investment in the years to come. Other people buy a second home to enjoy right now as a place to escape the weather, to gather with friends and family, or to relax and pursue leisure activities. And then there are people who consider vacation properties to be prime investments.

We purchase goods and acquire assets to help further a lifestyle for ourselves and the people who are close to us. This is what motivates us to build and maintain an investment portfolio over a period of time. So the fact that there is a cost to a vacation property should not dissuade anyone from making such an investment if their main objective is to enhance the time they spend with friends and family. On the other hand, if you are considering the purchase as a financial investment, a number of factors need to be identified and evaluated to assess the potential effect on your overall portfolio.

The purpose of this article is not to convince you whether or not to buy a secondary residence or vacation property, but to help you clarify your own reasons for doing so and to assess the potential financial viability of the investment.

Examine all of the variables affecting cost

As it has been said many times before, there are three considerations in real estate: location, location, and location. Because of this, the assumptions made about the value of real estate can vary dramatically from place to place, and from time to time. At White Oaks Wealth Advisors, we have identified a few basic issues and probabilities that will affect the financial results achieved by investing in real estate.

With that in mind, don't rely on this article alone as you consider purchasing property for investment. It is important to look at a wide range of factors, along with your own personal objectives, as you evaluate such a decision.

Some of the issues that should be considered include the following:

Property values. It's often the case that people visit a particular area during a vacation and decide to look at properties for sale while they are there. Yes, I've done this myself, and will probably continue to do so. It's very easy to get swept up into the emotional aspects of a vacation property when you're enjoying time away in a new place. The properties can seem very attractive in that kind of environment. Be sure to look at several different properties and do your own investigation of relative property values in the area, and how a specific property stacks up relative to others.

Hidden costs. It's also easy to oversimplify the process of evaluating a property investment by only focusing on how much you paid at the initial purchase and how much you expect to receive when you sell it. You must take into account all of the costs related to the transaction. These include the net interest costs after taxes of carrying the property for the period that you owned it. You will have closing costs at the purchase and sale of the property.

Also factor in any potential improvements made to the property. In addition, people usually spend a fair amount of money redecorating a vacation property to fit their tastes. The furniture purchased for the vacation home will have very little value upon sale, and so, consequently, it should be considered in the overall cost of the property. And, finally, real estate taxes are anywhere and everywhere, and should be considered on a net, after tax cost basis as you consider the valuation of a property.

Maintenance costs. Of course you will pay utilities to keep the property supplied with water, electricity, heating and cooling. Also many vacation properties are part of a homeowners association, and the association fee should also be considered as a cost of maintaining this property.

Estimate your break-even point based on rates of appreciation

In Table I, we have identified four possible scenarios that could occur in the valuation of a vacation property. These scenarios assume that we will not rent out the property. About half of the clients who consult with us about purchasing a second home do not consider renting their property out to someone else. They worry that the property will not be kept up well, or they don't want other people living in property they are ultimately purchasing for their own use.

Columns one through four show the differences in annual appreciation that might be experienced from the real estate investment. General home appreciation in Minnesota for the last year was about 10.2 percent, and averaged about 10.6 percent over the last three years. This is an abnormally high rate. The 10-year average is about 6.3 percent, and the five-year average is about 8.4 percent. This compares favorably with the national rate of appreciation—4.3 percent over 10 years. As with all investment assets, real estate is cyclical in nature. Recently, we have had some greater price appreciation and it is uncertain how long that will continue.

As an example, in Daytona Beach, Florida—another popular vacation spot—the average appreciation over the last year was 10.2 percent, however for the last 10 years it has averaged 3.2 percent. Last year the Phoenix-Mesa area appreciated at 7.1 percent, and in the last 10 years has averaged 5.4 percent. Myrtle Beach, South Carolina, has similar numbers with 7.3 percent for the last year and 4.5 percent appreciation over the last 10 years. With Baby Boomers buying vacation properties at a higher level than previous generations, these numbers are surprising low, relative to what we might have believed anecdotally about real estate prices.

That being said, you can place your own assumptions because we've looked at an annual appreciation at 4 percent, close to the national average, 6 percent, 8 percent, and 10 percent.

Table I

Purchase Price	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Annual Appreciation	4%	6%	8%	10%
Sales Costs	10%	10%	10%	10%
Closing Costs	$5,000	$5,000	$5,000	$5,000
Holding Period	5	5	5	5
Taxes	$ 2,000	$ 2,000	$ 2,000	$ 2,000
Maintenance	$ 4,400	$ 4,400	$ 4,400	$ 4,400
Mortgage Net	$ 1,199	$ 1,199	$ 1,199	$ 1,199
Mortgage Rate	6%	6%	6%	6%
Down Payment	$ 50,000	$ 50,000	$ 50,000	$ 50,000
Inflation 3%				
Gross Sales	$ 305,249	$ 337,212	$ 372,461	$ 411,327
Net Sales Proceeds	$ 274,724	$ 303,491	$ 335,215	$ 370,194
Interest Costs	$ (58,322)	$ (58,322)	$ (58,322)	$ (58,322)
Closing Costs	$ (5,000)	$ (5,000)	$ (5,000)	$ (5,000)
Improvements/Firn	$ (21,665)	$ (21,665)	$ (21,665)	$ (21,665)
Utilities	$ (12,742)	$ (12,742)	$ (12,742)	$ (12,742)
Taxes	$ (10,618)	$ (10,618)	$ (10,618)	$ (10,618)
Net Proceeds	$ 166,377	$ 195,144	$ 226,868	$ 261,847
Tax Savings	$ 27,576	$ 27,576	$ 27,576	$ 27,576
Net After Tax Proceeds	$ 193,953	$ 222,720	$ 254,444	$ 289,423
Mortgage Payoff	$ (186,376)	$ (186,376)	$ (186,376)	$ (186,376)
Net Cash Out/Benefit	$ 7,577	$ 36,344	$ 68,068	$ 103,047
Return on 50K	0	0	6.19%	14.55%

These scenarios further assume the purchase of a $250,000 property. This can vary by location and by personal preference, but provides a good number for a starting place. As you can see, five years later, the gross sales price has appreciated considerably. Even at 4 percent, our $250,000 house will appreciate to $305,249. Now if we had actually gotten 10 percent appreciation, there would be over $100,000 more, appreciating to a value of $411,327.

Many people would further assume that with a $50,000 down payment, 4 percent appreciation allowed them to double their money in a period of five years. However, there were a number of related costs during this period.

First, there would be the costs of selling the property. The property can be sold on its own, but generally a sale would require appraisal fees and the cost of a realtor. We've assumed these to be roughly 10 percent. Also, there is the cost of carrying the 6 percent interest rate. It's likely that money was spent on property improvements, furnishings and utilities. We've estimated $21,665 in furnishings and improvements, and $12,742 in utilities. With $10,618 in property taxes, we end up with a net number of $166,377.

Of course, we could save some taxes over that period of time. We calculated that with the maximum tax bracket at 35 percent, plus state taxes, we would have saved an estimated $27,576 over that period of time. This gives us a total proceeds of $193,953. Our net mortgage pay-off is $186,376, giving us a total cash out of $7,576. At this level our $50,000 is not there. We have lost around $43,000 on the property.

On the other hand, we can look at this as the investment paid for the use of this property and the fun that we've had staying there. We wouldn't have paid rent on other properties during this time, and so that should be calculated into this equation as well.

However from a pure investment standpoint, absent any rentals, the return on the $50,000 is negative.

Moving over to the next column at 6 percent appreciation, we have a similar experience, except that we have a higher gross sales price, but we still don't have our $50,000 back. At 8 percent appreciation, finally, we've actually gotten a return on our investment of about 6.19 percent over that five-year period of time. That's not an unattractive rate of return.

If we had rented a property instead of purchasing, we could assume a one-month stay at a value of $3,000 per month—again that number can vary widely—and over the five-year period of time, we would have invested $15,000. In other words, in order to come out ahead in purchasing the property, we would have required a minimum of 8 percent appreciation to make things come out well for us on a financial basis.

At 10 percent, we assume that the appreciation rates that we've had for the last few years are going to continue for the next five years. While that is possible, we wouldn't put a lot of faith in this scenario for the long term. However, if it were possible, our actual net rate of return would be 14.55 percent, a very attractive investment over a period of time.

Consider the financial benefits of renting out a vacation property

Of course the possibility exists that we could purchase the property and rent it out to others. This dynamic can change the financial outcome considerably, as you can see in Table II.

Let's assume we purchase the same property, but we rent it out for $2,800 per month for three months. While a more sophisticated method of calculation for rental properties could be used, we feel this approach tells the story adequately. I've used this assumption primarily because most properties of a vacation type are used on seasonal basis, and the busy season typically averages three months.

This would also allow us personal use of the property for two or three weeks each year. The total rent received in this scenario would be $43,330, increasing our total benefit considerably. It would not, however, give us enough overall benefit to justify only a 4 percent appreciation. Over that period of five years, we would have merely gotten our money back over that period of time.

<u>Table II</u>

Rental	4%	6%	8%	10%
Gross Sales	$305,249	$337,212	$372,461	$411,327
Net Sales Proceeds	$274,724	$303,491	$335,215	$370,194
Interest Costs	$58,322	$58,322	$58,322	$58,322
Closing Costs	$5,000	$5,000	$5,000	$5,000
Improvements/Furnishings	$21,665	$21,665	$21,665	$21,665
Utilities	$12,742	$12,742	$12,742	$12,742
Taxes	$10,618	$10,618	$10,618	$10,618
Net Proceeds	$166,377	$195,144	$226,868	$261,847
Tax Savings	$27,576	$27,576	$27,576	$27,576
Net After Tax Proceeds	$193,953	$222,720	$254,444	$289,423
Mortgage Payoff	$186,376	$186,376	$186,376	$186,376
Net Cash Out	$7,577	$36,344	$68,068	$103,047
Rent Received	$43,330	$43,330	$43,330	$43,330
Total Benefit	$50,907	$79,674	$111,398	$146,377
Return on 50K	1.81%	9.40%	16.13%	21.68%

At 6 percent of appreciation, however, we actually do come out with a positive rate of return of 9.4 percent. Eight percent appreciation would result in a 16 percent rate of return. And, finally, at 10 percent appreciation, we ring the bell with a rate of return of 21.68 percent.

Clearly, renting gives the investor the edge in having a real estate investment pay off for them. It is not without risk however. Projecting that you'll receive rent for three months each year is different than actually receiving it. Rental seasons can vary, and we can have situations such as the period after the September 11 attacks when people don't want to travel and vacancies may be higher than normal. On the other hand, we might be able to rent the property out for a longer period of time. It is possible to rent properties in the off-season to permanent residents and generate income that way as well. Real estate tends to be a hands-on investment. Unexpected expenses for maintenance and repairs are often necessary, and these possibilities have not been factored into our costs.

In summary, the purchase of a vacation property is often a very personal decision. We have attempted to identify some of the costs and some of the issues that you may face in making this decision. But regardless of cost, this can be a good investment in personal lifestyle and enhance the quality of the time you spend with friends and family. And, clearly, that is what we expect the accumulation of financial resources to do for us.

If we can help you walk through this decision, we would be happy to do so, and would provide you with a specific analysis based on your individual circumstances and situations.

If you would like to learn more about the financial services provided by Robert J. Klosterman and White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit <u>www.whiteoakswealth.com.</u>

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