

## Want To Invest in Real Estate?

Consider these 5 tips before adding an investment property to your portfolio.

Investment properties offer several appealing possibilities to people looking to grow their wealth. Leasing to tenants generates passive income and rent may cover mortgage payments. Real estate investments can be a good hedge against inflation, since rising costs can be passed on to tenants. They also have the potential to appreciate over time, providing a potential capital gain, and they come with certain tax advantages, such as the ability to deduct expenses and depreciate costs over time.

Even though interest rates are on the rise, they still remain historically low, which makes taking out a loan to purchase real estate more achievable for the

average investor. Yet, in addition to the potential benefits of owning investment properties, there are also important drawbacks aspiring real estate investors must consider. Here's what you need to know before closing a deal on an investment property:

### **NOT ALL LEASES AND TENANTS ARE THE SAME**

Buying a property that already has long-term tenants can have advantages, not the least of which is receiving rental income immediately. Before you make an offer, you'll need to know whether tenants are on long-term or month-to-month leases and how much they're paying. If the tenants are on month-to-month leases and exit once you take ►

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over, leaving behind damaged apartments, you may be worse off than you would have been if the property were empty when you bought it.

If there are existing tenants, be sure to understand the answers to the following:

- Will the security deposit and last month's rent (if applicable) be transferred to you before closing?
- What are the landlord's responsibilities and what are the tenants' responsibilities?
- Has the landlord made any promises to the tenants outside of the lease?
- What is the tenants' payment history? Are they behind on rent?
- Is the rent comparable to that paid for similar properties in the area?

### BEING A LANDLORD COSTS TIME AND MONEY

Rental income is passive, but property management isn't. Landlords need to find and vet tenants, make sure rent is paid on time, perform regular maintenance and field calls from tenants about repairs and pest control. That's true whether you're leasing to long-term tenants or offering short-term vacation rentals through a site like Airbnb. You can hire a property management firm to take over many of these responsibilities, but their fees will affect your return on investment.

Other common costs include:

- **Landlord insurance:** Insurance to provide property and liability protection.
- **Taxes on rental income:** The rent you collect will be taxed at ordinary income tax rates.
- **Accounting and marketing:** You may need to hire professionals to advertise your property and help you track your income and tax obligations.
- **Vacancies:** Many landlords expect to need 10% to 15% of their rental income to cover mortgage and utility payments on vacant apartments.
- **HOA fees:** If you're renting out a condo, you may be on the hook for homeowners' association fees.
- **Legal fees:** You'll need to engage an attorney to serve tenants legal notices and evictions.

### YOU'LL NEED CASH ON HAND

To secure a mortgage for an investment property, lenders may want you to have cash reserves equal to up to 12 months' worth of mortgage payments. (Loans for a primary residence usually require up to six months' worth of cash reserves.) If the monthly payment for an investment property works out to \$1,500, that would mean setting aside \$18,000 in addition to the cash you'll need to make your down payment. Cash reserve requirements can vary lender to lender – check with yours ahead of time to see what they require.

You'll also need cash savings to cover major repairs you'll need to make right away, such as burst pipes or a broken water heater.

### BUYING UNDEVELOPED LAND HAS ITS PROS AND CONS

If you'd rather not deal with property management issues, you can buy undeveloped land and sit on it with the plan to sell it at a profit at some future date. The big advantage to this strategy is the lack of administrative headaches – no building to maintain, no renters to deal with. On the other hand, it can be more difficult to secure a loan to buy it, and it doesn't generate income while you hold onto it. You're banking on your ability to sell it at a profit later, which may or may not pan out.

Here are some important questions to ask when considering buying undeveloped land:

- Are you confident that land will increase in value? What are the specific, local trends you see that will eventually drive demand for this plot of land?
- Is it zoned correctly? Check local zoning laws to understand what type of building can be built on the site. If you plan to sell it to a housing developer, be sure it is zoned as residential property.
- How many lots can it be divided into? Local zoning laws may define minimum road frontage and other requirements for individual lots.
- Does it have access to the necessary utilities? If not, are you confident that it will someday?
- What are the regular expenses of owning the land? There may be costs besides property taxes. For example, you may be on the hook to pay for utilities access even without a building on the property. ►

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### **YOU CAN INVEST IN REAL ESTATE INDIRECTLY**

Becoming a landlord isn't for everyone. You can add real estate to your portfolio without directly buying or selling property by buying shares of a real estate investment trust (REIT). A REIT is a company that owns and manages income-generating properties, including residential buildings, warehouses, commercial timberland, retail spaces, hotels, healthcare facilities, data centers and even infrastructure like power lines and cell phone towers. The company then divides profits it collects from rent among shareholders.

You can buy individuals shares of REITs or access them through mutual funds and exchange-traded funds. Direct investment in private REITs is restricted to accredited investors.

An investment property can be a great way to generate income and build equity, but if you're new to real estate investment, it can be easy to make costly mistakes. Your Baird financial advisor can help you consider whether an investment property is the right fit for your portfolio and help ensure that you get the most out of your investment.

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