

# SPECIAL REPORT

# Luxury High Rise Condominium Investing

By

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## Overview

Luxury high rise condominium investing, like any particular real estate investing technique, is not right for everyone. The purpose of this article is to help those interested in this type of investing to evaluate the risks, rewards and make a personal determination of individual suitability.

There are several reasons why an investor would consider investing in one or more luxury high rise condominiums, not the least of which is pride of ownership and in some cases, occasional personal use. However, in most cases the primary investment objective of the luxury high rise condo investor, as is generally the case with most luxury property investing, is long term equity growth.

In certain very robust markets, luxury properties can generate large capital gains in very short periods of time. If the property is a new development as opposed to a resale of an existing unit, there may be certain restrictions imposed by the developer in order to prevent or severely restrict rapid resale (less than one year) or a pre-close contract assignment sale.

There are many factors driving luxury high rise condominium development in the United States. A growing population, including a large and affluent “baby boomer” generation, and a generation of “echo boomers” who are waiting to marry and start families for financial and social considerations, are shifting their sites from a suburban to a more metropolitan lifestyle. Last, but certainly not least, decreasing amounts of developable land in densely populated and highly popular economic, social and resort areas is forcing developers to build and market properties which go vertical. Vertical buildings help developers get greater yield from a fixed amount of land and offset higher land costs.

## Market Considerations

The first and most important question in considering any type of new product is whether the demand in the market place is sufficient to absorb the proposed new inventory. In most cases, developers and financiers would not embark on a project which they weren't very confident the local market would absorb. However, in certain overheated economic seasons, a frenzy of business can develop which drives developers, lenders and investors to be more aggressive than usual. Therefore, a prudent investor is wise to examine the conditions prevalent in any given market and rely upon a healthy dose of good old common sense to help guide them.

The ideal market for new development investing occurs when the factors which are driving demand are identifiable, several and likely to continue. When these conditions exist, even if a market becomes overbuilt (supply meeting or exceeding demand), it is generally a temporary situation and the new inventory is eventually absorbed. In this case, the investor may not make a large profit, but loss potential is significantly mitigated. Quite often, time heals most wounds in real estate.

In the ideal market, a robust local economy is present with increasing incomes and real estate equity, job creation, incoming migration of both people and business. Most importantly for luxury property investing, the region should be a desirable area for first and second homes for affluent people - either still working or retired. Many people will buy a luxury property in a resort area as a second home, sometimes with an eye toward retirement. Still others will look for these types of properties to rent on a short to mid-term basis during whatever the peak season is as a way to offset some of the cost of ownership.

In summary, the ideal market is robust and growing, a tourist destination, with a limited supply of premium properties relative to demand.

## Property Considerations

The single most important consideration for a proposed new property, luxury or otherwise, is that it actually gets built! Unfortunately, some developments simply never materialize. Sometimes this is because

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the developer is undercapitalized or fails to anticipate significant obstacles such as rapidly increasing costs in labor or materials, construction permitting entanglements and other regulatory delays, or inadequate demand for their particular product. Inadequate demand may exist, even in an otherwise active market, if the product is poorly positioned against other competitors in the same space. Sometimes, a developer in a hot market will simply sell a project to another developer before it is built because the appreciation on the land alone is so attractive.

Product design and positioning is probably the most easily recognizable and important consideration where the investor's common sense can be of most use. In typical residential rental property investing, it is usually a big mistake for an investor to look at the property as if they were the occupant. Most investors would not necessarily like to live in their rental properties and so they struggle to see the property through the tenant's eyes. However with a luxury property, most investors can easily relate to the target occupant, so it is easier to develop a personal feel for whether or not the project is well positioned against any competitors in the area.

Some important questions to consider are:

- Who is the target buyer?
- What is the target buyer looking for in a property of this type?
- What else is available in the area?
- What are the strengths and weaknesses of the property relative to any competition?
- Why would the target buyer prefer this property over others which may be available?
- Are there enough qualified buyers (demand) to absorb all of the current and upcoming inventory?
- What is the capacity of the market to expand supply to meet growing demand?

Essentially, the evaluation of appreciation potential distills down to supply and demand, and location, location, location!

### Financing Considerations

There are several important items to consider when it comes to financing:

- What types of loans are available to *me* on *this* property? Remember, just because a loan program is available doesn't mean you or the property will actually qualify for it. This is particularly important with high rise condominiums. Most lenders view condo-hotels in a completely different way than residential condominiums. Work closely with a financing consultant who is well versed in these types of properties.
- How much money is needed by when? If acquiring an existing property, the escrow period will dictate fairly plainly the time frames. However, when acquiring a pre-development property the sequence of events is a little more complicated. A typical scenario might look like this:
  1. Place a reservation with a deposit pending the execution of a formal purchase contract. Each reservation agreement is different, so read it carefully to make sure you understand your rights and obligations, as well as those of the developer.
  2. Make a full or partial deposit with the execution of the formal purchase contract (the amount of deposit is often determined by the developer or the developer's construction lender based on an assumed loan-to-value of a purchase money mortgage).
  3. Provide an additional deposit or receive a deposit refund at close of escrow based on the loan-to-value ratio of the actual purchase money loan you obtain to close the acquisition and how much you have already deposited. For example, if the developer required a 20% deposit, but at the actual close you successfully funded using a 90% loan, then you would receive the overpaid 10% deposit back – and vice versa.

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Working with the developer, your real estate agent and your loan broker, you should be able to create a reasonably accurate funding time line. If you are buying more than one pre-development property, it is critically important to coordinate the demand on both your cash *and* your credit, so you are reasonably certain you will be able to fulfill all of your contractual obligations. Failure to do so can result in the loss of the property, loss of all or part of your deposit, and potential liability to the developer. Worst of all, if you are an active investor, you also tarnish your reputation!

- Where is the money coming from? Once you know how much you need and when you need it, you have to shake the piggy bank and figure out where the funds are coming from. Because the bane of an active professional investor is idle assets, it is very important to coordinate liquidity with demands for cash. Credit lines, cash out refinances on equity in other property, private funding via partnerships or debt, or liquidation of other non-real estate assets such as stocks, bonds and CD's may require advance planning. The point is: Have a plan and don't procrastinate!

### Acquisition Funding Strategies

The persistent challenge facing every investor is that of acquisition funding. Traditional acquisition funding typically consists of a down payment (from whatever source) and conventional financing (usually from a bank). However, there are other methods and variations on the traditional theme which an investor might consider.

#### Cash

There is nothing fancy about paying cash, except most people don't have enough cash lying around to buy even a small duplex, much less a luxury condo. Even if an investor had cash, he or she probably wouldn't want to use it because it eliminates the benefit of leverage and would likely create a taxable positive cash flow. While positive cash flow is desirable, paying taxes is not. This is a topic beyond the scope of this article, but as a rule of thumb it is generally more attractive to pay interest than tax. When paying interest, you get a loan, which in turn controls a property, which in turn provides cash flow, tax deductions, and capital appreciation.

So why pay cash? If one has the cash available and a developer or other buyer needs to unload a property quickly, cash can solve the seller's problem while providing the cash buyer with a discount (found equity). After the seller has exited, the purchase can "season" (typically six months to one year), and then be refinanced at a higher appraised value.

#### Cash with a Loan

This is the traditional formula which is understood by virtually everyone. The buyer simply makes a down payment and gets a loan for the balance. The twists are where the down payment funds come from and where the loan comes from and how it is serviced. Most of the rest of what we will discuss in this section are variations on **Cash** or **Cash with a Loan**.

#### Retirement Account (with or without a loan)

One of the most underutilized sources of investment capital for real estate is individual retirement accounts. Many people simply do not know individual retirement funds, including traditional and Roth IRA's, rollover 401k accounts from former employers, and self directed pension plans can be used to invest directly in real estate. Part of the reason for the confusion is the largest marketers of retirement accounts are stock brokerages, banks and insurance companies – none of whom sell real estate. Once again, this topic could be the subject of an entire book by itself. In fact, one excellent book on the subject is *IRA Wealth* by Patrick Rice. For now, we will focus on just a few important items to keep in mind when investing in real estate using a self-directed Individual Retirement Account.

No Personal Use – If one of your motivations for acquiring a luxury property is to enjoy it yourself, then using your retirement funds is not for you. The basic condition the IRS imposes for the wonderful tax breaks afforded retirement accounts is that the investor cannot receive any current benefit without penalty

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until after age 59-1/2. Also, your ascendants (parents, grandparents, etc) and your descendants (children, grandchildren, etc) cannot use the property. However, your best friend, your business associates, even your siblings can! Conversely, you can use property held by their accounts.

Partnering with Retirement Accounts – If your retirement account is insufficient to buy a property outright, you can elect to partner with your own retirement account – or the retirement account of another person. For example, your retirement account might acquire a 70% interest in the property while you held the other 30% in your own name outside the retirement account. Another scenario might be that your retirement account takes a 50% interest, while your friend's retirement account (or your friend in his or her own name) could take the other 50%. There are many variations on this concept.

Retirement Account and a Loan – Even though it has been legal for retirement accounts to own real estate since IRAs were introduced in 1974, it is only recently that conventional lenders are beginning to offer loan programs for properties held in retirement accounts. In this scenario, your retirement account makes the down payment and also secures and services a loan for the balance of the purchase price. There are certain items to be aware of including Unrelated Business Income Tax (UBIT), but the use of leverage on real estate held in retirement accounts can be a very attractive way to invest retirement funds directly into real estate.

If you are interested in utilizing retirement funds to invest in real estate, you should work carefully with your tax advisor and a retirement account custodian with experience in this subject. One such custodian is Pensco Trust Company ([www.pensco.com](http://www.pensco.com)).

Equity Sharing – Since the introduction of 100% loans by conventional lenders, equity sharing as an acquisition strategy for homeowners has waned. Nonetheless, this technique is still very useful to investors – especially because the conventional lending industry does not offer a broad amount of 100% financing programs for investment property.

Equity sharing is essentially a partnership where two or more persons or entities acquire a property and split the ownership risks and rewards. The terms of the split vary from partnership to partnership, but the motivation is to acquire a property which neither party could obtain individually. Debt may or may not be involved and much discussion should go into determining roles, responsibilities and rewards for each party before actually getting into a deal. Investors should always talk things through carefully and then engage the services of an experienced attorney to create a written agreement which represents the understanding of all parties.

Equity as Cash - Many people in highly appreciated areas have accumulated large amounts of equity in currently owned properties. In some cases there is so much available equity, a property or group of properties could be refinanced and the idle equity converted into cash. These cash proceeds can then be used to invest in other properties – effectively transferring equity from one property to another.

For example, someone with \$200,000 in available equity in a highly appreciated property could convert the equity to cash for a monthly payment of only \$1,000 using an interest only loan at 6% interest. The \$200,000 could then be used to pay cash for a \$200,000 property which is held for 5 years. If the property rented for \$1,000 per month and tax deductions are factored in, the property might generate enough cash flow to pay for nearly all of the payment on the \$200,000 loan. Meanwhile, if the property is appreciating at 10% per year, the property is adding \$20,000 per year of new equity to the investor's net worth!

In these scenarios, it is very important to work closely with your tax advisor and real estate finance consultant to carefully and accurately calculate your cash flows. It is also important to maintain adequate cash reserves to make sure there are plenty of resources to absorb unexpected expenses and disruptions in rents.

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Equity Arbitrage – Arbitrage is simply a fancy word for making money on “the spread”. This is what a bank does when they “borrow” money from you by paying you a modest 2-4% annual interest for your savings while they turn right around and loan it out to your neighbor at 6-25% interest on car loans and credit cards. If you could borrow money at 6% and loan it out or invest it at 20%, how much 6% money do you want to borrow? One popular answer is “All of it!”

The idea behind equity arbitrage is to borrow enough money out of one property to make a down payment on another property, but keep enough cash on hand to make the payments on the original loan during the holding period of the second property. The rents and tax deductions on the second property cover all the operating expenses and debt service of the second property, so the end result is there is none of the investor’s earned income or cash reserves being invested into acquiring or holding the second property!

If the second property appreciates sufficiently, the investor can enjoy a positive growth to their balance sheet (net worth) without any negative impact to their cash flow statement (lifestyle).

Let’s take a look at a hypothetical example:

Assumptions:

- You want to purchase a \$600,000 luxury condo (“Property B”) which won’t be delivered for two years.
- The developer is requiring a 20% deposit at contract.
- You plan to hold the luxury condo for an additional two years and then sell it and move the equity into another property.
- You already own a highly appreciated property (“Property A”) with a current fair market value of \$500,000 and loans of \$150,000 at 7% interest, giving you \$350,000 in total equity.

Now, let’s do some math!

Purchase Price	\$600,000
20% deposit due at contract	\$120,000

Since the property will not be built for two years, your \$120,000 will control the property for two years until the property is completed and ready for delivery. At that time, you will need to complete the transaction by bringing an additional \$480,000 – presumably from a purchase money mortgage.

Sounds great, you say – except for one challenge. You don’t have \$120,000 sitting around! True, but you do have a large amount of “idle” equity in Property A. In order to get the \$120,000 for the necessary deposit on Property B, you elect to borrow it from a bank by replacing your \$150,000 mortgage on Property A and with a \$290,000 loan at 7% interest. After paying off the old \$150,000 loan, you are left with \$140,000 of cash. However, your monthly payment (interest only) would be \$817 per month higher than that of the original \$150,000 loan. Of course, if your \$150,000 was fully amortized, the actual difference might be less, but for purposes of this discussion, let’s assume the larger loan is costing you \$817 per month more.

Because you don’t want to make the \$817 per month payment from your own paycheck or pre-existing cash reserves, you allocate the cash proceeds from the new loan as follows:

New Loan Cash Proceeds	\$140,000
Deposit on Property B	<u>-\$120,000</u>
Cash Proceeds remaining	\$ 20,000

After placing the \$20,000 remaining cash into an interest bearing savings account, you establish an automatic payment program from the account to make the \$817 payment each month. At this rate, the \$20,000 will last approximately 24 months ( $\$20,000 / \$817 = 24$ ). In effect, you have made the loan pay for itself for two years! In other words, by pledging Property A as collateral, you were able to get the bank

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to give you enough money to make the down payment on Property B and service the loan for the two years until the property is built.

This may sound interesting, but does it make good business sense?

When you started, you had \$350,000 equity in Property A and no equity in Property B for a total of \$350,000 in combined equity. In the new scenario, you have \$210,000 equity in Property A (\$500,000 less \$290,000 new loan) and \$120,000 equity in Property B for a total combined equity of \$330,000. At the beginning of the period you start with \$20,000 in cash, but over two years these reserves will be depleted from making the \$817 per month payment. But what else is happening to your portfolio?

You started with \$500,000 of “top line” (fair market value irrespective of debt) real estate. Now, with the addition of Property B, you have top line of \$1,100,000. The difference, of course, is the \$600,000 value of Property B. Since Property A will appreciate at the same rate whether you buy Property B or not, we will ignore Property A’s impact on your finances. Later, we will revisit Property A as it appreciates. For now, let’s look at how your ownership of Property B might affect your finances.

If Property B is valued at \$600,000 at time of contract, even though you haven’t yet taken possession or secured a purchase money loan, and have no ongoing responsibility to tenants and taxes, you still “own” it – and its appreciation during this time. Let’s now consider the effect of this appreciation which is called “paper equity” because it only exists on paper and cannot be realized until the property is actually built and the purchase is completed. Nonetheless, as long as the property is built and you close the acquisition, the paper equity is still value to you:

Property B Acquisition Price: \$600,000

<u>End of Year</u>	<u>New Value at 10% Annual Appreciation</u>	<u>New Equity</u>
1	\$660,000	\$60,000
2	\$726,000	\$66,000
	Total New Equity:	\$126,000
	Less Cost of Borrowing:	\$20,000
	Net Gain:	\$106,000

Based on the above chart, it appears that the \$20,000 of excess loan proceeds on Property A is adding significant net worth to your financials by allowing you to control the \$600,000 Property B for the two years of pre-construction. Of course, at this point it is only “paper equity”, but assuming you continue forward and take delivery on the property when it is done, you are doing quite well!

Let us now project the two years of ownership after you take delivery.

As you approach taking delivery on any property, it is wise to do a detailed cash flow analysis. With luxury condo investing, the amount of income will vary depending on how the project is set up and managed. For purposes of this first cash flow analysis, we will assume there is no income being generated for the entire two year period after you take delivery.

Upon close at the end of Year 2, your purchase price remains \$600,000 even though the appreciated value at 10% per year is \$726,000. However, your purchase loan amount will be based upon the contract price and not the appreciated value, so an 80% loan would be \$480,000. Assuming an interest rate of 8% interest only, your loan payment would be \$3,200 per month. Add in taxes and insurance of \$600 per month and Homeowners Association (HOA) of \$200, your total monthly outflow is \$4,000 per month. If the property sits vacant for the next 24 months, your total holding cost is \$96,000. But we’re not finished yet.

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You still have the original \$120,000 loan you used for the deposit and its associated \$817 per month payment. You will also need another \$20,000 to make the payment for the remaining 24 month holding period. In order to cover the \$20,000 plus the \$96,000 in negative cash flow, you will need \$116,000 in additional reserves. Where might you get this? Let's go back to the bank and revisit Property A.

If Property A started out at \$500,000 and appreciated at 6% per year, your equity would look like this:

End of Year	Fair Market Value	Loans	Equity	Avail Equity at 80% LTV
1	\$530,000	\$290,000	\$240,000	\$134,000
2	\$562,000	\$290,000	\$272,000	\$160,000

As you can see, even at just five percent appreciation and an 80% loan-to-value ratio, there is enough equity in Property A to pledge as collateral to the bank for the \$116,000. Of course, in order to cover the additional payment for two years at 7% interest only, the actual loan increase would need to be approximately \$135,000. This would bring the total new debt (remember, you started with \$150,000) on Property A to \$140,000 + \$135,000 = 275,000.

Now that we have secured funding to cover the next two years holding expense, let's go back and look at Property B (the luxury condo):

End of Year	New Value at 10% Annual Appreciation	New Equity
1	\$660,000	\$ 60,000
2	\$726,000	\$ 66,000
3	\$799,000	\$ 72,000
4	\$878,000	\$ 80,000
Total New Equity:		\$278,000

At the end of year four, based on 10% annual appreciation, your \$600,000 luxury condominium is now worth over \$878,000. At this point, the decision is made to sell:

Sales Price	\$ 878,000
Less 6% sales commission	-\$ 53,000
Less "new" debt to be repaid on Property A <sup>1</sup>	-\$ 275,000
Less repayment of loan on Property B	-\$ 480,000
Before tax net profit	\$ 70,000

\$ 70,000 / 48 months from contract to resale = \$1,458 per month average gain

Based on these projections, the appreciation<sup>2</sup> of Property B was sufficient to cover all the acquisition, holding and sales expense and still yield a before tax net profit of \$70,000. Additionally, because the property (a luxury condominium) sat empty for the entire two years after delivery, you (the owner) would have the ability to enjoy it personally or share it with friends and family any time of the year. By simply using Property A as collateral for two loans, one at contract and one at delivery, and then using Property B for collateral for a purchase money loan at delivery, you were able to control Property B while retaining Property A. This allowed the capture of the appreciation on both properties, the personal enjoyment of using the luxury property any time over the two years from completion to resale, and a \$70,000 profit without any contribution from pre-existing cash reserves or sources of income.

<sup>1</sup> Property A started with \$150,000, but an additional \$275,000 in debt was added in two phases. The proceeds were those used to make the down payment and cash reserves for holding Property B from contract to resale.

<sup>2</sup> These figures are purely hypothetical. Each investor must examine any particular market place and property, review the related historical appreciation and drivers thereof, and decide whether the probability of adequate appreciation is satisfactory. Obviously, there can be no guarantee of appreciation, availability of funding when needed, or stability of interest rates.

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The above only addresses the potential for capital gain. Let us now consider the affect of potential rental income from a luxury condo (Property B).

The income potential of luxury properties varies greatly depending on where they are located, how they operated, and what type of rental they are suitable for. For purposes of this discussion, we will be operating on the following assumptions<sup>3</sup>:

- The project is suitable for nightly rental
- 365 total available rental nights per year
- 30% vacancy percentage = 110 nights per year
- 14 days per year reserved for owner's use
- \$250 per night average monthly rental value
- 50% of gross rental income paid to hotel operator / management company

When we take these assumptions to project potential income, here is what we find:

Total available rental nights per year	365
Less vacancy at 30%	- 110
Less days reserved for owner's use	- 14
Days rents	241
<u>Average gross rental income per night</u>	<u>x 250</u>
Gross rental income per year	\$ 60,250
<u>Years held for rental income</u>	<u>x 2</u>
Total gross rental income over 2 years	\$120,500
<u>Less management split</u>	<u>x 50%</u>
Owner's pre-tax rental income for 2 years	\$ 60,250

Based on these assumptions, Property B has contributed \$60,250 of income over the two year period of time from delivery to resale. When combined with the profit from appreciation previously illustrated, we calculate the total pre-tax profit on this hypothetical investment after 4 years (2 years from contract to delivery followed by 2 years from delivery to resale) as follows:

Net profit from capital gain realized at resale:	\$ 70,000
<u>Net profit from rental income</u>	<u>: \$ 60,250</u>
Total realized profit before tax	: \$130,250

Over a 48 month control period, Property B has contributed an average of \$2,713 per month to the investor's before tax finances. All of this was achieved using nothing but the bank's money and pledging Property A and B as collateral.

There are a few other items worthy of note:

- Because Property B was held for the production of income, it may be eligible for a 1031 tax deferred exchange at resale.
- Depending on the individual investor's tax situation, the depreciation on Property B may completely offset any income tax currently due on the rental income.
- The value of the 14 days of owner's use per year, which amounts to 28 days over the two year period from delivery to resale, provide a non-cash benefit to the owner valued at \$7,000 (28 days x \$250 per night rental).
- Travel expenses related to visiting Property B may be tax deductible because the luxury condominium is being held as in investment. Depending on one's tax bracket, this might mean a "discount" of as much as 50% on travel expenses to the resort area where the luxury property is located.

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<sup>3</sup> As is the case with the assumed appreciation rates used in these examples, so also the figures used for these income projections are purely illustrative and are not intended to reflect any particular property or marketplace. Every property and circumstance is unique and each property's potential for income will vary.

### **The Speculation Specter**

Some thoughts not only relevant to the topic of equity arbitrage, but to the entire concept of equity investing, have to do with the argument raised by some that this type of investing is purely speculative and therefore more dangerous than other types of real estate investing. The author agrees with the notion that equity investing is “speculative”, but would also argue that to a large degree all investing is in fact speculative.

In the common vernacular, “speculation” is a euphemism for “gambling”. The idea being that a gambler has no control and the game at hand is one merely of random chance over which the gambler has no control or influence. In certain types of gaming, such as slot machines and dice, the author would tend to agree. We do not see “professional” slot machine players. There is no skill involved in simply dropping coins in a machine and pulling a lever.

However, one of the more popular “sports” today is poker. There is even a world series of poker! This is because the game of poker is not one of random chance, but one of pursuing target outcomes based in one’s skills as determining and responding to probabilities. In other words, knowing when to “hold ‘em”, “fold ‘em”, “walk away” or “run”. A skilled poker player, while subject to the “luck of the draw”, also has the ability to manage probabilities and make decisions about how to react to a variety of ever changing variables as they manifest. Is this to suggest that equity investing is akin to playing poker? Not at all. Poker requires far greater skill to be successful. The point is there are varying degrees of risk, based on probabilities and one’s ability to react appropriately to them.

Before we proceed, let us examine the technical definitions of “speculation”. From an English dictionary, we find the following definition:

spec-u-la-tion<sup>4</sup>

1.
  - a. Contemplation or consideration of a subject; meditation.
  - b. A conclusion, opinion, or theory reached by conjecture.
  - c. Reasoning based on inconclusive evidence; conjecture or supposition.
2.
  - a. Engagement in risky business transactions on the chance of quick or considerable profit.
  - b. A commercial or financial transaction involving speculation.

From a financial dictionary, we get a somewhat different definition:

speculation<sup>5</sup> - The taking of above-average risks to achieve above-average returns, generally during a relatively short period of time. Speculation involves buying something on the basis of its potential selling price rather than on the basis of its actual value.

It appears the thought is: it is “risky” to buy something based on something you hope will happen as opposed to something that has in fact already happened. Just as a poker player places a bet “hoping” for a favorable card, so a speculative investor buys hoping for a favorable return in the form of future income and/or capital gain.

If one stops and applies this same logic to “investing” in obtaining a college degree, one might conclude that it is risky to go to college. Is the student not paying for a degree based on the hope of getting a better paying job? There is no guarantee the graduate will earn more income as a result of having a degree. In

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<sup>4</sup> Source: *The American Heritage® Dictionary of the English Language, Fourth Edition* Copyright © 2000 by Houghton Mifflin Company. Published by Houghton Mifflin Company. All rights reserved.

<sup>5</sup> Source: *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor* by David L. Scott. Copyright © 2003 by Houghton Mifflin Company. Published by Houghton Mifflin Company.

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fact, there is no guarantee the graduate will even be able to find a job at all. The graduate (or his or her parents) will have invested a large sum of money, not to mention time and effort, into obtaining the degree based purely on the hope of a yet unknown future job with presumably more income than that of a person without a college degree. Yet, most people would not consider this speculative because the probabilities are favorable. The common argument in favor of the substantial investment of time and money into obtaining a college degree is, "Sure, there is no guarantee. But historically people with college degrees earn more than those that don't and the chances are there will be a good job out there somewhere waiting for the graduate." Could not this same line of reasoning be applied to purchasing a luxury condominium or any other property based on the probability of appreciation? "Sure, there is no guarantee. But historically nice properties in nice areas tend to appreciate above average – and the average is over 6% which includes all the properties which don't appreciate at all. The chances are good that someone of means will be willing to pay a premium price for premium property in a premium area – especially since there aren't as many premium properties and premium areas as people who want them and can afford them."

In terms of conservative real estate investing (investing in existing properties for cash flow from current market rents), an investor makes a down payment, secures a purchase money loan with a personal guarantee, and then hopes the property will generate sufficient rental income to service the debt, pay all operating expenses, and produce an acceptable level of profit to the investor. Of course, there are no guarantees the units will rent, or that the rents will be sufficient to cover the debt service and expenses. There are many factors outside the owner's control, such as income tax rates, mortgage interest rates, property insurance rates, local economic factors affecting employment (demand for housing and capacity to pay), and of course, the tenants themselves. There are no guarantees the tenant's will not do more damage to the property than the value of the rental income they contribute. In other words, even with a "conservative" approach, there are a host of unknowns outside of the individual investor's control. In truth, there is no such thing as "risk free".

This isn't intended to sour you on investing in real estate, but simply to break the paradigm that cash flow investing is not speculative. The truth is there are many factors outside of the investor's control and the best one can do is to make wise decisions based on probabilities. Evaluating and managing the probabilities is the essence of being a successful investor, whether for cash flow or for equity.

This author would argue there are many identifiable factors which contribute to appreciation. In any given market place these factors should be identified and evaluated for their probability to continue. If the factors which caused a market place and property to appreciate in the past remain active and healthy, does it not seem reasonable these factors, or drivers, might continue and therefore drive further appreciation in the future?

Perhaps the best definition of what causes the "Speculation Specter" is *Reasoning based on inconclusive evidence; conjecture or supposition*. Fear of the unknown causes many investors to pause, stop and sometimes retreat. Just as charging forward blindly is foolish, so is retreating blindly. A wise investor will reason through the evidence, evaluate the options and their probabilities for success, utilize appropriate safeguards to mitigate risk (insurance, cash reserves, emergency exit strategy, etc), take appropriate action, monitor progress and results, and make adjustments accordingly. The good news is that of all the various types of investing, not the least of which is the ubiquitous technique of buying and holding stocks, real estate investing (including that of acquiring luxury condominiums for equity growth) is among the most easily understood and controlled by persons of average skill and intelligence. When one considers how many people "bet" their future on pieces of paper (stock) representing ownership in businesses they don't understand, can't control, shares of which trade at lightning speed in a worldwide exchange inhabited by ruthless, nameless, faceless professionals, the notion that purchasing world class real estate in highly desirable areas based on the "hope" it will go up seems like the safer bet. But that is just this author's opinion and you must form your own. After all, it is your money and your future.

The key to safety in any investment where debt is involved is the precise management of cash flow and the maintenance of adequate cash and credit reserves to weather unexpected expenses or decreases in income.

Cash flow controls mortgages and mortgages control property. When you are pursuing the property's appreciation over time, the most fundamental component of success is proper cash flow management and liquidity.

### **Entrance Strategy and Timing**

The two best times to acquire new development property are either very early in the development or at the very end. The early approach capitalizes on a builder's motivation to get some sales early for construction financing considerations. On the other hand, buying from a developer at the end of a project leverages the developer's motivation to finish up and move on. If the project has been a success, by the time the last properties are being marketed all of the project costs have been covered. In this case the developer may more readily reduce pricing to close things up.

Your timing and approach will depend partly on what you are trying to accomplish, your risk tolerance, and the opportunities you have awareness of and access to. Obviously, the best opportunities are snapped up quickly – and often before the properties are ever made available to the general public. Finding great opportunities is often the result of consistent and strategic networking and relationship building.

### **The Phased Equity Approach**

“Phased Equity” is the result of the higher prices of future releases of segments or phases of a particular development pulling up the pricing on the previous phases. There are several causes for this type of appreciation and it is very important for the astute investor to determine what is causing the increases and whether the increases are likely to be accepted by new buyers. Causes or “drivers” of phased appreciation include:

- **Low Price Leaders** – Sometimes developers need to show the construction lender a certain amount of pre-construction sales activity in order to secure a release of funds to begin construction. In these cases, a developer may initially market the first phase at very competitive prices in order to attract initial buyers. The idea is the developer's profit will come from later releases.

For example, suppose a developer were planning to build 100 homes for a total project price of \$10 million. Assuming each property were identical, the price per property would be \$100,000. In order to secure an initial number of buyers to show the construction lender, the developer may choose to sell properties 1-20 at only \$90,000 for an aggregate value of \$1.8 million. This would mean the remaining 80 properties would need to sell for at least \$8.2 million in order to produce an aggregate of \$10 million in sales. The \$8.2 million generated by selling 80 properties means each property would be priced at \$102,500. Assuming new buyers were willing to pay the \$102,500, the buyers who bought the first phase for only \$90,000 now have comparable properties selling for \$102,500. The extra \$12,500 in value is called “phased equity”.

Obviously, there is no guarantee new buyers will pay a higher price simply because the developer needs to sell for that price to cover costs and earn his profit. If the developer finds he is unable to sell at the required pricing, he may choose to cut back on quality and extras as a way to regain his profit margin. In this case, the early buyer has a superior product which presumably will result in greater demand in the resale market down the road, thus mitigating some of the risk of slow absorption.

- **Supply and Demand** – Continuing with our previous example, if the developer finds the demand in the market will allow him to successfully sell properties 21-40 for \$102,500, he may decide to “push the market” and increase the prices on properties 41-60 a little bit more. At this point, the developer is no longer motivated by simply achieving a minimum profit margin, but rather he is now pursuing whatever extra profit he can obtain from the market. The more demand for the limited supply of product will result in buyers paying more as long as they have additional purchasing capacity. The advantage of luxury properties is they tend to attract people with substantial means.

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- Increasing Costs – Land, labor and raw materials are the three primary components of cost for a developer. Increases in any or all of these will force a developer to increase the price of the final product in order to cover the costs and return a profit margin. Once again, in any given market, the developer's ability to pass on costs will be dictated by the relationship of supply, demand and capacity to pay. If demand is sufficient, supply is inadequate, and buyers have capacity to pay<sup>6</sup>, then the developer will likely be successful at passing on the increased costs. Even if the developer is only successful in passing on costs and cannot realize any additional profit, owners of earlier projects and phases will enjoy appreciation based on the higher price.

As an owner of an asset which is valued by comparable properties, the fact it costs more to build the same product helps drive up the prices of new properties. Or, as stated previously, make your property more desirable as new products are downsized or otherwise diminished as the developer struggles to make a profit.

### **Risks**

The above is a discussion on some of the factors which can make early phase entrance attractive. But what are the risks to buying a property which doesn't yet exist?

#### Absorption

One of the significant risks in phased equity investing, especially pre-construction, is absorption – that is, the ability and willingness of new buyers to purchase the new inventory. Sometimes, an economy unexpectedly slows down while the building momentum continues, resulting in excess inventory relative to demand. In order to move the properties, developers are forced to lower prices. If you are an early phase investor, this can be painful!

#### Developer Failure

Until the property is built, it doesn't exist and you can't own it. This may seem rudimentary. But just because a developer says he will build it doesn't mean it will get built. If the developer fails, your deposits may be at risk. Therefore, it is wise to have some information about a developer's history and backing.

#### Interest Rate and Credit Volatility

When buying into a pre-development project where the product will not be delivered for many months – in some cases, two years or more – an investor who intends to use financing may find his or her credit rating or the prevailing interest rates have changed making the financing options available at the time less attractive than planned for. Of course, the reverse could also be true! Nonetheless, it is important to pay attention to interest rates and credit worthiness during the pre-development stages. If anything substantial changes, then cash reserves, loan sizes and down payment amounts and/or exit strategies may need to be adjusted.

#### The Existing Inventory Approach

Entering a market after a property has been built and absorbed by the market mitigates significant risk. However, it also eliminates significant opportunity. This isn't to say there isn't a lot of money to be made acquiring existing inventory. If a market is hot and several sustainable growth drivers can be identified, there will likely be a persistent demand for product. In areas where new supply cannot expand to meet the demand, as long as people have the capacity to pay, it is likely appreciation will steadily occur over time. Once again, this is the tremendous advantage of luxury properties. They attract buyers – and sometimes tenants – with significant financial wherewithal.

The key to successfully investing in existing inventory for equity growth purposes is to use optimal leverage and utilize the rental income and tax breaks to generate cash flow to pay all or part of the debt

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<sup>6</sup> A buyers capacity to pay is typically a factor of interest rate and employment rates, however when investing in luxury properties, it is important to remember many buyers have significant capacity to pay regardless of interest or employment rates!

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service and operational costs. This is no different in luxury properties and cash flow management is the single most important aspect of an investor's holding strategy (which we will discuss shortly).

From an entrance point of view, the acquisition of an existing luxury condominium for investment purposes, the optimal entrance point will vary – and is more a matter of capitalizing on circumstances. Just as a developer may want to unload units to get out quickly and get on to something else, so might many of the inexperienced investors who purchased a new unit without a plan or adequate financing. While it is never pleasant to capitalize on someone else's misfortune or poor decisions, unlike foreclosing on a family, it is unlikely a “don't want” in the luxury condominium space is going to be homeless if they dump their property. Remember, the reason they are selling it is because they don't want it. If you do because you see a bright future and have a plan, then you can solve the seller's problem while picking up a bargain.

Ultimately, good decisions about entrance strategy and timing depend on understanding what is occurring in the market in regard to supply and demand, trends, and a particular seller's situation and motivations.

Once again, finding these opportunities comes down to having direct contact with people who will be aware of these opportunities when they come up – and like you well enough to call you when they find one!

### **Holding Strategies and Techniques**

The key to successful real estate investing of any type is to gain control of a property and hold it until the target profit is realized, whether that profit comes in the form of cash flow, equity or a combination of both.

With luxury property investing, the emphasis is typically on gaining equity growth – over time or relatively quickly (when one is fortunate enough to end up with a hot property in a hot market). In some cases, an investor may receive the non-monetary “dividend” of personal use. If you are an investor who travels to luxury resorts frequently (or would like to!) this added feature can produce tangible financial benefits. These benefits include tax deductible<sup>7</sup> travel (you are visiting your investment property), and reduced out of pocket expense for accommodations and/or more luxurious accommodations for the same or less money.

The actual holding strategy you employ will depend to a large degree on a number of circumstances imposed by external factors. These factors include financing options and developer restrictions and/or supports.

### **Financing Options**

Assuming you intend to finance your luxury property, the types of loan programs available to you will vary greatly based on the property type, your credit profile, and prevailing interest rates at the time of application. A wise developer will often research the types of financing options available to prospective buyers during their project planning phase. Why build a project people will struggle to buy due to a lack of attractive financing? However, some developers fail to give adequate consideration to this very important part of their project plan, so an astute investor should have at least a preliminary financing game plan in mind before fully committing to the purchase.

Conventional lenders rely heavily upon the ability to resell their loans in the secondary market as way to replenish their funding capital. To a lender, money is the inventory they sell. If they run out, they have to shut their doors. Therefore, it is very important for a lender to write loans which can be quickly and easily resold. Typically, the less risk associated with a loan, the more attractive it is to the secondary market. Risk factors include the borrower's credit history, the loan-to-value ratio, the size of the loan and the quality of the collateral (the property). Unfortunately, certain property types are less attractive to the secondary mortgage market than others.

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<sup>7</sup> This article is not intended and should not be relied upon as authoritative tax advice. Tax laws and strategies change and each investor's situation is unique. Always engage the services of a qualified tax professional.

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Lenders look at the subject property and consider how easily they could sell the property for the value of the loan balance in the event of foreclosure. Keep in mind, lenders do not want to foreclose and they do not want the property. If they end up with it, they want to unload it as quickly as possible. They deal in paper (money), not property.

Properties occupied by owners are considered to be less risky to loan on. Single family homes are the safest. Condominiums stacked no more than two to four stories high are generally considered to be single family homes. Condominiums which are part of a taller complex are often thought of by lenders as glorified apartments – and therefore more likely to be non-owner occupied, so lenders charge more for these loans and/or do not allow as high a loan-to-value ratio.

In the realm of luxury condo financing, the basic options in order of lender risk (from lowest to highest) are:

1. Owner occupied
2. Second home
3. Long term rental (may be restricted by the CCRs<sup>8</sup>)
4. Short term rental (may be restricted by the CCRs)
5. Condo-hotel

The matrix of loan programs and all of the related variables are far too complex to address in this article. Suffice it to say that lenders typically charge more (higher rates mean higher payments) and lend less (lower loan-to-value means more down payment). A diligent investor should be aware of their own credit history and work closely with a knowledgeable financing consultant when projecting acquisition and holding costs.

The mission critical purpose of thinking carefully through one's holding strategy is to make sure there is a viable plan to meet all the cash requirements for acquiring, operating, maintaining, and debt servicing the property until the target exit is reached. If you lose control of the financing, you will lose control of the property. When that happens, everyone loses.

In summary, make sure you have a plan for financing the acquisition and holding of the property. Consider adding some cushion into your calculations so if something doesn't go as planned you have some maneuvering room.

### **Developer Restrictions**

In response to an increasing number of opportunistic speculators who have entered the real estate market, and in particular the luxury condominium market, many developers are now imposing restrictions on how, and even if, they will sell units to investors. Any developer restrictions will have a direct and profound impact on a potential investor's holding and exit strategies.

For example, certain developers will not sell to investors at all. Obviously, there is no need for a holding or exit strategy if you can't acquire the property in the first place! However, assuming you are able to acquire a property, some of the items to consider before actually closing the deal might include:

- Restrictions on Contract Assignment - If you are unable or unwilling to close on the completed unit, but can find someone else who would want to purchase the property, are you allowed to assign the contract and take an assignment fee? Many developers frown on this practice because you have not closed and funded (which is what the developer really wants), you have introduced an unknown and potentially less committed buyer who may not close, you have cashed out *your* equity without helping the developer liquidate his (by funding), and worst of all, if all the developer's inventory hasn't sold,

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<sup>8</sup> CCR stands for Covenants, Conditions and Restrictions. CCRs are the rules which all owners are required to agree to follow in regard to the use of the property.

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you may be actually competing with him in the marketplace. This isn't to say you shouldn't assign a contract and take a profit if the developer will tolerate it, but be sure to consider how doing so may affect your relationship with all of the people involved and whether you plan to do any business with any of them or anyone they know in the future. Then act accordingly. The world of real estate investing is small and your reputation is valuable – build it and protect it carefully!

- **Restrictions on Unit Use** - Are you allowed to rent out the unit? Are there any restrictions related to renting? Certain developments cater to a mixture of owner occupants and permanent resident tenants. To provide a stable environment for the owner occupants, a developer may include restrictions on daily and weekly rentals. In other cases, a complex may be designed specifically to attract short stay tenants (typically tourists) to generate daily and weekly rental income for the investors and adjacent businesses.

Always remember to consider the project's overall positioning in the market as intended by the developer. Strive to make your use during the holding period consistent with the developer's vision for the project. If the unit can't be rented, or the comparable market rent is inadequate to allow you to safely control the property until exit, you probably don't want to buy it. The bottom line is you can't afford it.

Don't waste everyone's time and money buying a unit you can't close on or can't control until the exit.

### **Developer Supports**

Just as a developer's restrictions affect an investor's options for holding a property until exit, so also does the support an investor receives as a result of how the developer has organized the project. If you are careful to align your holding strategy so that your use is consistent with the developer's plan for the project, you will usually avoid many of the unpleasant and expensive side effects which occur with a problem ownership. There are no problem properties, only problem ownerships. Very few properties are completely unsuitable and unappealing to everyone!

If a developer has designed a luxury property with a vision for creating a wonderful quality of life for affluent owner occupants, while they may restrict short term rentals, they may invest in special amenities, such as advanced security systems, high class fitness centers, elegant intimate gardens, and other expensive, but delicate items not suitable for a high traffic projects. Conversely, a development intended to attract a steady stream of rent paying tourists may be appointed with restaurants, shopping, entertainment, and other high volume services.

One of the great investor supports a developer can build into a luxury condominium project is on-site property management. If you plan to generate rental income to offset your holding costs, but aren't able or interested in maintaining your unit, marketing to and screening tenants, or otherwise dealing with the day to day operations of the property, then having an on-site manager will be a tremendous help and one you will certainly want to take advantage of. On the other hand, if a developer doesn't provide this type of support and you need it in order to effectively operate your property then you will have to evaluate the feasibility of organizing this for yourself.

Listen carefully to how the developer or his representatives describe their project. Consider the "big picture" and who the developer has designed the project to attract. If you want to utilize rental income to help mitigate your holding costs, even though the developer allows and supports this, you will want to consider whether the project will attract enough of the right kind of people.

**Astute Investor Tip:** Read the contract! Verbal representations made by exuberant sales people or desperate sellers are very difficult to enforce. What does the contract say?

## **Exit Strategy and Timing**

With pre-construction investing, and luxury condos in particular, exit strategies and timing will be heavily influenced by what the market conditions are actually like when the unit is delivered and how long you might be required to hold on to it before you can exit. Therefore, it is less important to have a firm decision about exit strategy and technique, but rather to have a fundamental understanding of the variety of options available. This awareness of exit options combined with a clearly identified exit objective, such as a certain date or amount of profit, will help you determine when and how to exit.

From an exit perspective, luxury condominium investing is not unlike ordinary property investing. In the case of an exit which involves selling the property, the primary difference is in recognizing the most ideal and likely buyer may not be another investor, but an owner occupant.

There are a variety of exit strategies and techniques available to investors. Among them are:

1. Reservation Assignment
2. Contract Assignment
3. Quick Flip
4. Lease Option
5. Long Term Equity Optimization
6. Long Term Cash Flow Optimization
7. Tax Deferred Exchange
8. Tax Free Owner Occupant Sale

Let's briefly review each of the options:

1. Reservation Assignment – This is when the buyer gains control of a property through a reservation process, but even before signing a purchase contract or putting up additional deposit money, assigns the reservation to another buyer (for a fee) who then takes the original buyer's place and enters into the purchase contract. The assignment fee is the original buyer's profit. This technique works best when an extreme demand exists for a unique property. Most developers will not allow reservation assignment when demand for the product is high because it is more profitable for them to cancel your reservation and resell the property at a higher price to a new buyer. Read the reservation agreement carefully, but keep in mind you may be able to negotiate an exception. If you do so, it is essential to get the exception confirmed in writing.
2. Contract Assignment – Similar to a reservation assignment, the original buyer executes a contract with modified language to permit assignment to another party. Later, when a substitute buyer is found who is willing to pay the original buyer a fee to take over the contract, the contract is assigned and the new buyer closes on the purchase at the original buyer's price and terms. Many developers will not allow this and absent any language in the reservation agreement affirming contract assignment, it should not be assumed the developer will allow it. Once again, read the agreements carefully and, though you may be able to negotiate exceptions, do not count on anything not affirmed in writing.
3. Quick Flip – In this case the buyer actually closes on the initial acquisition and then immediately resells the property to a third party at a higher price. In order to prevent early phase buyers who close before all the developer's inventory has been sold, certain developers will place contractual limitations on immediate resale. There are two reasons for this. First, the developer doesn't want to compete with current owners to sell his inventory. This competition could potentially reduce the price for the both the developer and the reseller. For this reason, even if you plan to simply resell the property and take a profit, it is wise to wait until the developer has sold out his entire inventory. Another consideration is how many other owners are planning to flip. If a large number of properties are introduced to the market at the same time, the price may be reduced. Even if your plan is to quickly resell the property, it is very wise to be in a position to hold the property long enough to allow the market to absorb the inventory. In extreme high demand scenarios, the wait won't be long if at all.

4. Lease Option or Lease Purchase – A lease to a long term tenant who holds an option, or in some cases a contract, to buy at a future date is a way to use the property to generate cash flow and tax deductions, while waiting for the tenant to exercise their option or perform on their purchase contract. Presumably the option or contract price provides an acceptable profit to the original owner. A tenant with a strong desire but current inability to own may be happy to lease the property for current use and enjoyment, hoping later to purchase the property.
5. Long Term Equity Optimization – Here, the owner holds the property for the long term, either for personal use or rental, and uses cash out refinances to convert idle equity to cash for deployment into other investments (or consumption).
6. Long Term Cash Flow Optimization – This isn't as much an exit strategy as a holding strategy, but is included here because it addresses how an investor might draw more cash flow from the property. Contrary to common myth, simply paying off the loan and owning the property free and clear does not optimize cash flow. At a certain point, taxes interfere with the investor's yield and it becomes preferable to pay interest on a new loan and redeploy the now liquid equity into additional income properties.
7. Tax Deferred Exchange – A tax deferred exchange involves selling a property which has been held "long term" (more than one year – check with a qualified tax advisor) for the production of income (a rental) and purchasing one or more rental properties using the same aggregate loan amount. Exchanging out of a property is a variation on a quick flip, but utilizes the considerable benefit of tax deferral. If one were to simply sell a property after a year and fail to employ a tax deferred exchange the before tax net profit would be taxable at the capital gains tax rate. If the resale occurred in less than one year, the tax rate would be that of ordinary income.<sup>9</sup>
8. Tax Free Owner Occupant Sale – If a property has been the primary residence of the owner for two of the last five years, then upon resale the before tax net profit up to \$250,000 for a single person and \$500,000 for a married couple is exempt from tax. Unlike a typical rental property, a luxury property may be very attractive to an owner to utilize as their primary residence for the final two years of their ownership. Keep in mind that tax law is subject to change and one should never count on a current law to be in place many years into the future, therefore it is advisable to keep up with major changes in tax law and review your situation with a qualified professional before actually executing a specific plan. Nevertheless, if a married couple purchases a luxury property which appreciated quickly and chose to live in the property for two years, they could sell the property and take up to a \$500,000 profit – tax free! Admittedly, they would have to "suffer" through two years of residency in a luxury property, but the tax savings could be worth it!

### **Individual Investor Considerations**

Not the least of all the things to think about when contemplating a particular investment is the matter of suitability. Although an investment might be ideal for someone else, is it ideal for you?

The first step in contemplating the suitability of a particular investment property opportunity is to "get in touch with your 'inner investor'". The idea is to think through a number of items related to your personality, current resources, risk tolerance, investment goals, and personal involvement. While this topic is far too complex to address thoroughly in this article, there are a few items we will focus on.

### **Critical Mass – Are We There Yet?**

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<sup>9</sup> Once again, this article is not intended to provide authoritative treatment of tax or law, but merely to provide the reader with ideas and commonly used techniques. Every investor should engage the services of a properly qualified professional in matters of taxation and law.

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For people who have not already reached “critical mass”, that is, enough capital and equity so they are able to purchase sufficient income producing assets to provide adequately for their needs, the preferred primary investment objective is equity growth versus cash flow. In other words, an investor who hasn’t developed critical mass yet should focus on investments which primarily build the asset base the fastest – as opposed to investments which simply feed the cash flow statement.

### **Equity Investing versus Cash Flow Investing**

When most people think about real estate investing, visions of a portfolio of properties producing monthly income comes to mind. Armed with this basic idea of their investment objective, novice investors (and many “experienced” ones as well!) will proceed to search for properties which will positive cash flow with next to nothing down. Unfortunately, there are very few of these properties in the real world and those that exist are snapped up immediately when they show up.

The challenge for most people is they need to bring purchase equity (down payments) to their income property acquisitions in order to get a loan small enough to allow the property to positive cash flow. Once current sources of purchase equity, such as savings and idle equity in properties currently owned, are deployed, the cash flow investor is forced to go to work, earn money, pay taxes, live below their means (which means swimming up stream against inflation) and save money aggressively for the next down payment. For most people of average means, it takes so long to do this they either give up or never acquire enough properties to develop the amount of positive cash flow they desire.

One of the keys to successful real estate investing is to develop “down payment machines”. These are investments and activities which produce sizable amounts of capital which can be used for down payments on future properties. Equity developed in fast appreciating markets and properties can later be converted to cash via a 1031 exchange or refinance and used for down payments on new properties.

### **Strengths and Weaknesses**

No two investors are exactly alike. Each individual investor’s current financial position is unique. There are four essential components needed to invest in real estate:

Cash – Liquid or easily liquidated assets which can be used for down payments, mortgage rate buy downs, cash reserves, and to subsidize negative cash flow.

Cash Flow – A steady monthly income to show the lender the borrower will be able to service the loan. Sources of cash flow include employment, rental income on the subject property, and investment income from sources other than the subject property.

Equity – The difference between what a property is worth and what is owed. As property values go up (appreciation) the owner’s equity increases. This equity can be converted to cash and used for down payments and cash reserves.

Credit – The borrowing power of the individual investor both in terms of a credit score and available credit lines which can be used for down payments and cash reserves.

Each investor’s personal investment strategy will depend to a large degree on what his or her individual strengths and weaknesses are in each of these four important areas. For example, someone with weak cash flow (not much discretionary income or the ability to quickly increase it in response to opportunities and challenges) would approach high leverage and potential negative cash flow differently than someone with very strong cash flow who could easily absorb negative cash flow.

It is very important for each investor to carefully assess his or her own situation and approach each individual investment and the overall portfolio in such a way as to leverage strengths and mitigate risk caused by individual areas of weakness.

### **Partnerships and Joint Ventures**

In cases where an individual investor is not capable or willing to take on a particular investment on his or her own, it may be wise to consider a partnership. Just as businesses occasionally strategically align themselves with other complimentary businesses in order to synergize and achieve something neither was

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capable of on its own, so too an individual may decide to “partner” in order to acquire properties which would otherwise be out of reach. In addition to seeking partners who bring financial strength in areas of your weaknesses and vice versa, it is also critically important to align entrance, holding and exit strategies when partnering with others. A written agreement and legal counsel is a very important and necessary component of organizing a partnership to buy, hold, manage and profit from a real estate investment.

### **Conclusion**

Luxury property investing is really simply a subset of everyday real estate investing, but also has some unique and attractive features. Luxury properties are generally more suitable for investors pursuing equity as opposed to cash flow and may provide the additional benefit of personal use. If the property is held for the production of income, it may be eligible for 1031 tax deferred exchange upon sale and travel expenses related to managing and maintaining the property may be tax deductible. Purchasing existing properties can help mitigate absorption risk, but pre-construction investing may allow an investor to control a property for many months for only a reservation and/or partial deposit – without actually having to immediately qualify for and service a loan. In the right market place, a limited supply of a unique property combined with a steady and rising demand, could yield significantly higher than average appreciation.

### **Continuing Education**

To continue your real estate investing education and networking, consider joining an Advisor Financial Alliance (AFA) Real Estate Investor Mentoring Club, part of AFA’s Real Estate Investor Development Program™. For more information, including dates for the next seminar or orientation, please contact WOW Events at 1-888-662-0668 or on-line at [www.wowevents.com](http://www.wowevents.com).

Advisor Financial Alliance ([www.AdvisorFinancialAlliance.com](http://www.AdvisorFinancialAlliance.com)) is a network of financial services companies and professionals dedicated to helping people build wealth through real estate. AFA’s Real Estate Investor Development Program™ is administered through WOW Events.

### **About the Author**

**Russell Gray** is a real estate investment strategist and the co-founder of Advisor Financial Alliance and the Real Estate Investor Development Program™. Mr. Gray is a former faculty member for the California Association of Realtors® where he taught real estate finance to real estate agents pursuing the prestigious GRI designation. He is an active real estate investor and a co-founder of several real estate related companies. Mr. Gray is a regular guest on The Real Estate Guys™ radio program, a popular speaker on the subject of real estate investing at investment clubs, college classes and seminars, and he is a key advisor to professional investor Robert Helms.

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