

# WHAT IS LEVERAGE, AND HOW TO MAKE IT WORK FOR YOU?

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Real Estate investment is unique from the stock market because with Real Estate, you can use leverage; and real wealth is achieved by using leverage. Buy Real Estate with a long-term goal and in time leverage will bring great wealth.

## What is Leverage?

In real estate, leverage is based on acquiring a real estate asset with little of your own money invested. You can obtain bank financing up to 75%-80% of the purchase price, and sometimes with secondary financing you can get up to 90% or even 100% of the total asset value through creative financing.

Therefore, a real estate value increase of 5 percent (appreciation rate) is by far a better investment than a stock increasing by 20 percent. This is because when you leverage an investment property, you reap the benefits of the appreciation on the total of the asset value, and not your cash invested.



As an example, consider the common real estate purchase requirement of a 20% down payment – or \$100,000 on a \$500,000 asset. The buyer is essentially using a relatively small percentage of his or her own money to make the purchase, and the majority of the money is being provided by the lender. Real estate investors often refer to the remainder of the purchase price as "other people's money," since persons other than the borrower provided the money needed to make the purchase. Assuming the property appreciates at 5% per year, the borrower's net worth from this purchase would grow to \$525,000 in just 12 months. A huge \$25,000.00 increase in value in one year.

If the same \$100,000.00 was used to buy stocks and the stocks had appreciated by 20% for the year...the resulting profit of \$20,000.00 would still be lower than the \$25,000.00 (5% appreciation) profit, from using leverage.

Furthermore, if the same investor used the \$100,000 to make an outright, paid-in-full purchase of a \$100,000 property and assuming the same 5% rate of appreciation, the buyer's net worth from this purchase would have increased by only \$5,000 over the course of 12 months versus \$25,000 from the leveraged, more expensive property. The \$20,000 difference demonstrates the potential net worth increase that is provided, with the use of leverage.

Now, assuming the \$500,000 purchase had an average of 5% appreciation every year for the next 20 years. The value in the 20<sup>th</sup> year would be approximately \$1,325,000.00. Over time, the use of leverage can have a significant, positive impact on your net worth.



## The Risk of Using Leverage

Just as leverage can work on your behalf, it can also work against you. Revisiting our earlier example, if you use a \$100,000 down payment to purchase a \$500,000 property, and real estate prices in your area decline for several years in a row, the leverage works in reverse. After year one, your \$500,000 property could be worth \$475,000 if it depreciates by 5%. A year after that, it could be worth \$451,250 - a loss in equity of \$48,750.

Under that same 5% price-decline scenario, if that \$100,000 had been used for an all-cash purchase of a \$100,000 home, the buyer would have lost just \$5,000 over the first year in which home prices fell.

To reduce the risk of using leverage, follow my tips;

- Do not use 100% (no money down) purchases. Invest at least 20% of your own money down on a purchase
- Always have a sizable cash cushion available, or access to cash if needed for emergency
- Purchase with a long-term goal. If the property value drops, it is only a paper loss unless you must sell when under duress. Remember that after the rain, the sun will eventually shine again.

Be patient with your Real Estate investment and in time leverage will eventually bring great wealth.

