

Is Purchasing Residential Rental Properties in Silicon Valley a Good Investment?

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For a long stretch of time, I would not consider investing or recommending investing in residential rental properties in Silicon Valley (SV) since the cashflow returns were substantially lower than other locations in the United States, until recently. I have just purchased an investment property myself, a single-family home in E. Menlo Park, and am starting to recommend doing the same to our investment clients. Here's why;

Before Building Your Portfolio, You Must Have Strategy

When considering investing in real estate, expected returns can be summarized by the following formula:

$$\text{Total Return} = \text{Cumulative Cashflow} + \text{Appreciation}$$

Over the years we have learned that while every investor wants to maximize their return by investing where both cashflow and appreciation are the highest, typically it does not work this way. Normally where the appreciation is high, the cashflow will often be lower, and when the cashflow is high, appreciation is lower.

As an additional benefit to the above Total Return Formula, investors get a tax benefit via depreciation which reduces their tax liability. Our investment strategy is a portfolio approach which combines holding properties in high appreciation areas and balancing the cashflow shortcoming with investing in high cashflow areas.

1. Real Estate Investing Basics: Understanding the Benefits and Drawbacks

- a. The Benefits of Real Estate Investing
 - i. Building an asset-base and creating equity for the future
 - Using OPM: Leveraging someone else's money by borrowing (mortgage)
 - Pay off principal: Someone else (renter) pays off your mortgage
 - Compounded appreciation: $\text{Future Value} = \text{Purchase price} \times (1 + r)^n$ [$r > 0$, appreciation / $r < 0$, depreciation]
 - Establishing a hedge against inflation in three ways:
 - Inflation erodes the value of your real debt
 - Rents appreciate with inflation
 - Home usually appreciates with inflation
 - ii. Produce income to supplement and/or build towards retirement
 - After paying all expenses, have monthly income for life!
 - Excellent resource for funding college tuition, supporting long-term care, sustaining retirement, and building emergency funds
 - iii. Government incentives
 - Deduct ALL expenses, unlike for your prime residence

- Depreciate improvements (paper loss, recaptures upon regular sale)
- Defer capital gains taxes via 1031 exchange

b. The Drawbacks of Real Estate Investing

I. Tangibles

- Search cost (inspection, appraisal, travel, etc.)
- Transaction costs (2%-6% buyer, 4%-7% seller)
- Ongoing costs: Interest, insurance, taxes
- Illiquid asset: takes longer to sell than stocks or bonds
- Administration (travel, phone, mail, etc.): potential added costs and/or effort
- Maintenance costs and management
- Vacancies (while paying bills): no rent coming in
- Evictions & property damage: potential issues with tenants

II. Intangibles

- Time (Avg. 2 hours/month/property)
- Frustration of having to deal with tenants, contractors, property managers
- Anxiety of ownership and obligation

2. Considerations for Investing in Silicon Valley real estate

a. Financial

- I. Investors who have too much positive cashflow from their real estate and not enough depreciation
- II. Your properties are generating small monthly rent but require too much time to manage
- III. Investors that own properties in low appreciation areas
- IV. Investors that want to consolidate the number of properties under management
- V. Investors that have a large amount of money to invest and don't want too many low-dollar value properties
- VI. Investors that are not interested in positive cashflow, only high appreciation
- VII. Investors who want to diversify their investment portfolio to include more real estate
- VIII. The quality of renters in SV is typically higher than in the lower price point communities, resulting in less hassle of ownership
- IX. If you live in SV, you need to ride the SV real estate appreciation index, else you'll be left out

b. Lifestyle & Personal Preference

- I. Your current house is not a good fit for your next phase in life (location, size, maintenance, etc.), buy now and benefit from the appreciation and lower property taxes.
- II. You believe in real estate investing but will invest only within short driving distance from current SV residence
- III. You are currently renting (can't afford to buy a home in your preferred SV location) but don't want to be left out of the SV real estate index

c. Family

- I. Want to establish foothold for family growth in SV
- II. Want to buy a house for aging parents
- III. Want to buy a home for your children

3. Know the Timing of the Real Estate Market

The Silicon Valley real estate market is a derivative of the local economy. On a macro level, the Silicon Valley economy is still very strong and has been growing rapidly since mid-2010, as can be seen by the employment chart Fig 1:

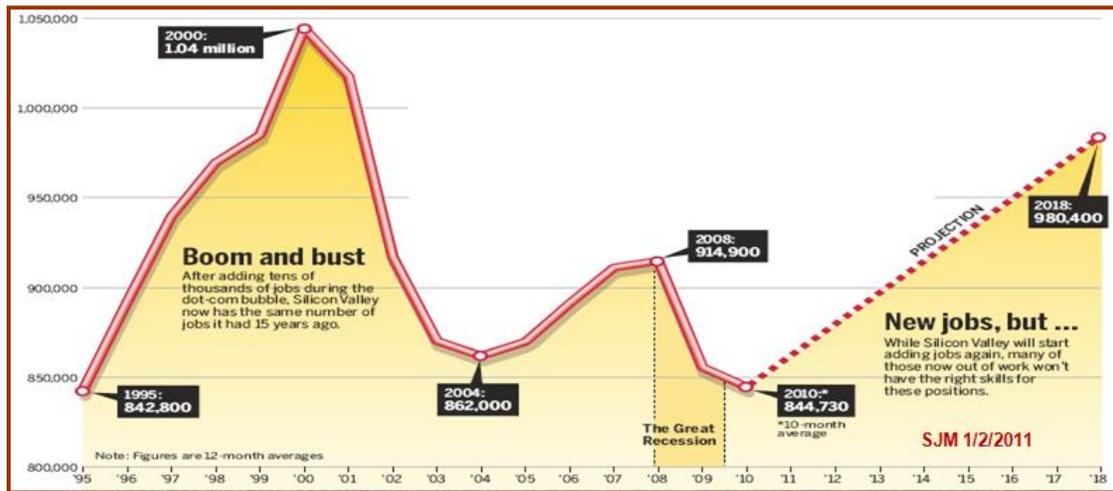


Fig 1.

Silicon Valley companies are doing very well. For a comprehensive analysis of our local economy read The 2019 Silicon Valley Index! (<https://jointventure.org/download-the-2019-index>).

Companies continue to hire thousands of workers each month. The April 2019 job gains is depicted in Fig 2:

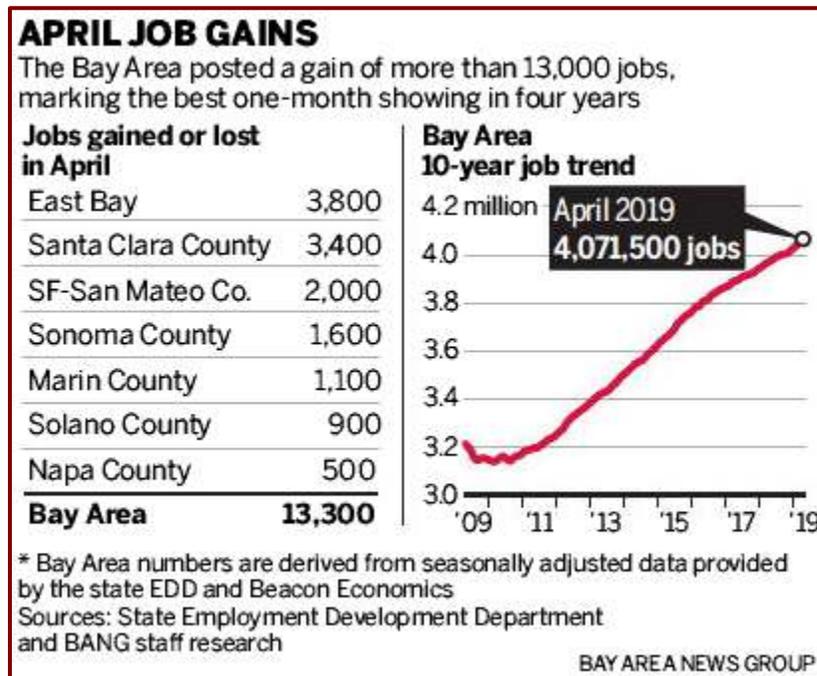


Fig 2.

In addition, the Silicon Valley real estate market is seasonal and heavily impacted by fluctuations of supply and demand throughout the year as shown in Fig 3.

As the next few charts show, in a typical year inventory levels are lowest between November and January and pick up again between June and August. Buyers are mostly in sync with the supply fluctuation except during the summer months when inventory levels are rising, and many buyers are on summer vacation. Once people are back from summer vacation and following the start of the school year, buyers are back in the market, but supply starts to drop, making the market more competitive and prices start to rise again.

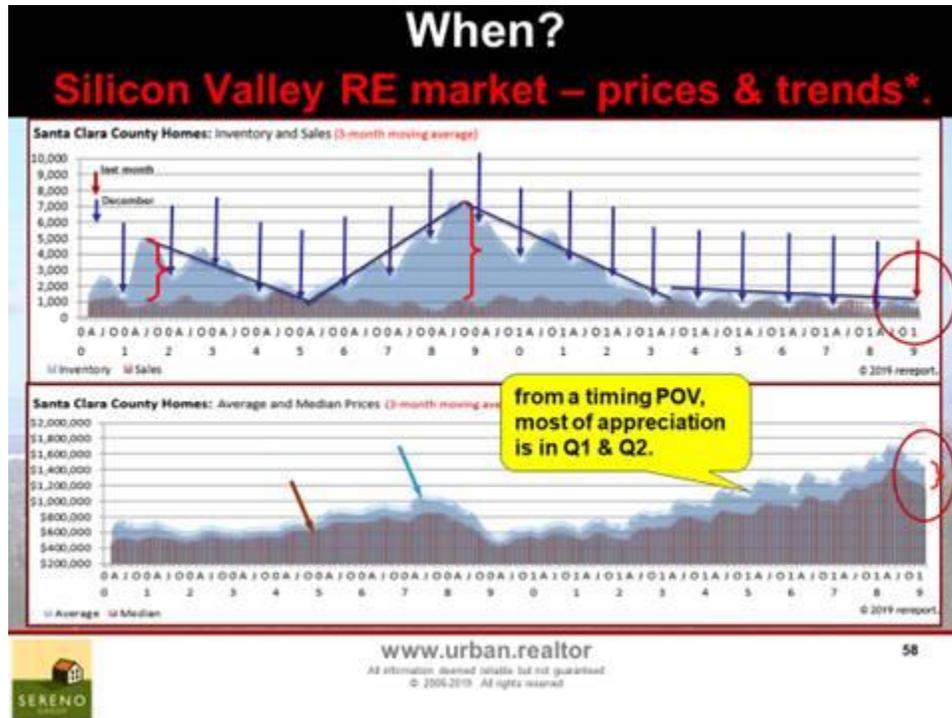


Fig 3.

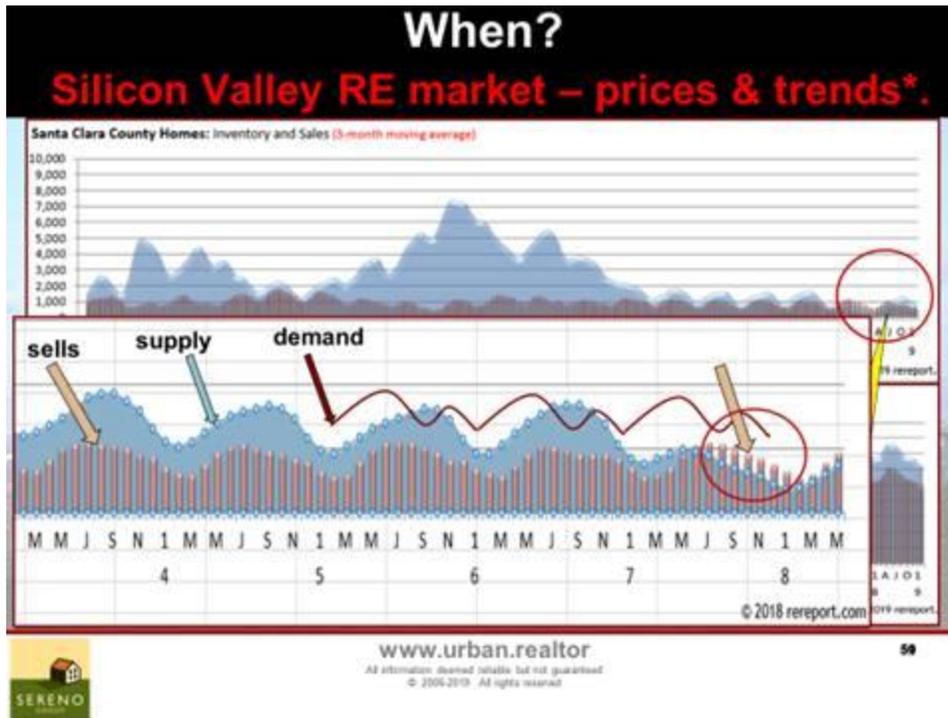


Fig 4.



Fig 5.

In addition, interest rates are coming down which makes the ROI even better.

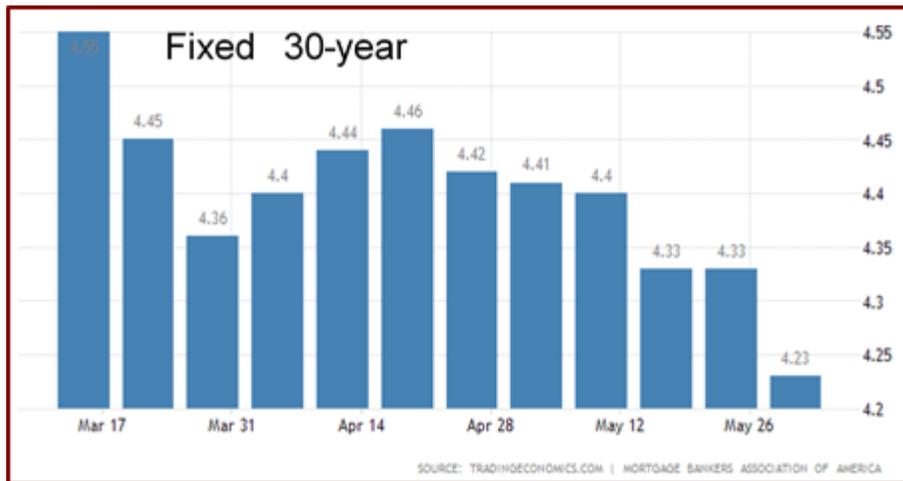


Fig 6.

4. Rent Control Impact

The cost of living in Silicon Valley is among the highest in the nation. A major component of this cost is housing. The area has one of the highest median prices in the nation and one of the highest rental costs too.

A 2015 decision by the Mountain View City Council to reject pleas from tenants to limit rent increases triggered ballot initiatives across the state and in various cities to impose rent control. This effort varies from city to city, and its full implication is not clear yet.

Currently, the focus of these initiatives is mostly on multiple-unit type of housing (triplex and higher) and is not yet, at least, targeting single family homes.

5. About The Urban Group

- Our home is Silicon Valley, our clients have high standards, and we help our clients sell and buy their Silicon Valley homes as well as develop their nationwide real estate investment portfolio.
- Our mission** as your **“whole-istic” Realtors** [helping with everything related to real estate] is **to educate** and **inform** our clients about the **real estate market** [seminars since 2005] and make them **smarter** and **wiser** consumers, **exceeding** all your real estate **goals**.

Our Commitment:

- To our Sellers:**
Sell your home for the **highest net proceeds** [verses price] at the **right time** [economy and real estate market], **without any hassles** or **problems** [before, during and after the transaction closes], with **superior service** and **integrity**.
- To our Buyers:**
Find you the right home [needs, desires, ability] at the **right cost** [verses price] at the right time [economy and real estate market], **without any hassles** or **problems** [before, during and after the transaction closes], **with superior service** and **integrity**.

- **To our Investors:**
Help you establish your real estate investment portfolio to meet your **short and long-term financial goals, without any hassles or problems** [before and during the holding period], **with superior service and integrity.**

Our Track Record

We have helped hundreds of clients develop a better understanding of the challenges and opportunities of owning real estate and helped them buy and sell homes in Silicon Valley as well as invest across the country.

Please take the time and read what clients are saying behind my back on [LinkedIn](#), [Yelp](#) and others.