

Does location dollar out?

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BLUE GRASS, Va—Every real-estate investor believes in the Three Commandments of successful property picking: Location, location, location.

Except me.

I'm a yes-no-and-sometimes man on these laws...as well as a few others.

The very best land deals I've done -- or had a hand in -- since 1970 had crummy locations. They did, however, have something better: Easily sold assets that were not dependent on location and which more than covered the cost of acquisition.

Location applied to a single-family residence (SFR) means good schools, good neighborhoods and reasonable access to employment opportunities. Most buyers looking for their own home try to buy as much good location as they can afford. A smaller house is often bought because it's in a better neighborhood, or a more expensive purchase is made for a house that carries the burden of a good-location premium.

Good location costs. For someone buying an SFR as an investment or rental unit, location needs to be "dollared out," as a local farmer friend of mine puts it. Will the good-location premium increase an investment's profit over time enough to justify the higher getting-in price?

The SFR investor may want to compare projected profit from a premium-burdened property with that projected from a less-burdened alternative.

Does good location always pay off; does it always dollar out favorably?

Take a theoretical example. The same house priced at \$600,000 because of good location might be priced at \$300,000 in a not-so-good location. Apart from whether the more expensive house is the better investment, is convenience and security worth \$300,000 in additional mortgage principal and at least twice that in interest?

Are there individual fixes -- high-tech house security, private school, big mutt -- that can make up for the cheap place's location disadvantages? If \$10,000 in fixes can make up most of the location disadvantages, the \$300,000 investment may prove to be more profitable on a percentage basis than the \$600,000 good-location alternative that carries the embedded \$300,000 location premium.

In very simplified terms, if \$40,000 in cash (\$30,000 in down payment and \$10,000 in fixes) leverages \$180,000 net profit in five years on the not-so-good-location house, the investor has used his money more productively there than taking \$60,000 in his cash to leverage a \$200,000 net profit on the expensive place. The ratio of 1:4.5 (\$1 invested to pocket a \$4.50 net) is more productive per dollar invested than a ratio of 1: 3.33, even though the investor ends up with \$20,000 more net with the less efficient investment.

Sometimes investors are happier with the larger net, but generally the more productive the invested dollar, the better off investors are.

Some location negatives, of course, can't be offset by private fixes. A used car can substitute for the lack of public transportation, but not much can be done to help a rental unit 100 feet from a ten-lane highway.

When comparing the two investments, the investor needs to project best-case, most-likely and worst-case appreciation rates for each. If the two appreciate at the same rate, the more expensive property will net twice the dollars. But that doesn't count what the investor did with the money he kept in hand by not investing in the pricier house.

While the good-location, big-premium property has the advantage of higher status and higher-income neighbors, the poor-location property may be the better investment.

If the location-disadvantaged SFR property is stuck with immutable negatives that will choke appreciation for the next 20 years, you're better off paying more for the location-advantaged property if a choice has to be made between only two alternatives.

The more sensible response, however, is to find more and better alternatives

Real money can be made in properties where location negatives can be offset and where they are likely to be improved—together leading to a higher rate of appreciation in the future than what might be projected using recent history. The house in an about-to-start gentrifying urban neighborhood is the classic example.

The success of most commercial real-estate ventures is much more directly linked to location factors -- proximity to services, convenient transportation, high traffic count, siting within a community of commerce -- than a residential investment.

As is the case with SFR investments, the commercial real-estate investor has to judge how much a particular location will change over time--and whether that will be towards improvement or deterioration.

But the same logic applies: Given the investor's resources, does it make more dollar sense to invest in the high-cost, good-location property or the lower-cost, lesser-location alternative?

Land and location

With land investments, location is often only one of several factors that determines ultimate profitability.

If you're investing in **natural resources** -- timber, minerals, oil and gas, wind energy, water -- the quantity and quality of the resource, feasibility of its exploitation and transportation, clear title and expected net profit are the primary determinants of value.

Location can become a very important value variable when the site of the resource is on or near public land, environmentally sensitive land (wetlands, floodplain, habitat for endangered species) or the property of potentially effective opponents.

In many cases, remote location of a natural resource discounts acquisition price but does not really discount the ultimate value of the production. North Slope oil is a very large example of how asset value trumps location disadvantage.

Timberland can be remote, but as long as it's physically and legally accessible, remote location doesn't erode the timber's stumpage value. Timber, however, does generally need to be within a four-hour or so truck haul to at least one mill. If a mill -- or better yet, competing mills -- are too far from the timberland to make haulage economically unworkable, the timber asset is worth nothing. Location has trumped asset in that example.

Farm investments can be location-dependent, as in the case of a farm-to-market organic operation or a pick-your-own berry patch dedicated to the urban weekend customer.

Conventional commodity farms -- row crops, orchards, livestock -- need to have access to their relevant marketing and transportation infrastructures, but proximity to a town or amenities doesn't necessarily increase the value of these farms. The quality of the soil, water, climate and the farm's infrastructure are more important determinants of value than closeness to a school or shopping mall. Owners of such farms often value location within a like-minded, like-producing farm community.

Location plays a role in the search for **individual retirement housing** in small towns and rural communities. Employment opportunities, good schools and convenient commuting are far less important as location drivers than peace and quiet, primary physician care, other health-care services, community entrepreneurship, church, low taxes, climate and proximity to grown children. Whether or not, a particular property has the attributes of conventionally defined "good" location can be an inconsequential factor. With retirement places, I've found that people want to relocate to areas where they find an existing

group of peers (income, status, religion and the like) supported by appropriate services.

My rural county of 2,500 has a number of location negatives, such as lack of shopping, difficult access, no Interstate, no local college, few developed amenities and so on, but the folks moving here are almost entirely retirees in their 50s. I should add that one of our draws is that we only have two practicing lawyers, one of whom is my wife.

Second homes in the country tend to define good location as proximity to recreation amenities, broadly conceived. These can include skiing, hunting, water activities, scenery and nature. Some second-homers would say that the closer they are to the magnet amenity, the better and more valuable the location. Others don't feel a social or economic need to wad up.

In second-home communities that are built around a package of recreation and services, location drives house value.

But in rural communities with second homes, neighborhoods are much more vague. Nice houses and not-so-nice houses mix together. Good neighborhood may not have as much meaning in these communities. One often sees an isolated second home of great value located in an extended neighborhood of more modest houses. The value of such homes do not seem to me to suffer a location discount, but it's certainly arguable that the same home sited among its peers would carry a higher price.

Location next to bad neighbors, however "bad" is defined, or rural negatives (dumpster station, quarry) always lowers property value.

Investors often look for rural second-homes that can segue into full-time retirement spots. The second home is an investment that can generate rental income and tax benefits. If it becomes a permanent residence, it still generates some tax benefits, and the tax-free portion of profit made on the sale of the antecedent principal residence can be used for retirement living expenses, not the purchase of replacement housing.

The cost of good location can dollar out or not, depending on many other factors. It's not a fool-proof rule.

My three rules of successful real-estate investing are: Pre-offer research. Pre-offer research. Pre-offer research.