6 Risks in Using Leverage in Real Estate and How to Avoid Them

Risk management must be practiced at all times in starting real estate business deals, especially if you're using leverage in doing so. Leverage can undoubtedly help you end up as a victor in your real estate deals and investments. However, it can also be the cause of your downfall if you overlook the risks it brings to your assets and finances. Multiple factors cause the riskiness of leverage that must be foreseen beforehand to make your real estate investments fruitful. In this article, we will show you several risks in using leverage in real estate and how you should avoid them.

What Is Leverage in Real Estate?

Before we talk about the risks, let's discuss briefly what leverage is in real estate. Leveraging in real estate is the process of optimizing return on investment (ROI) potential by utilizing debts. If you conduct a market analysis about the real estate industry, you'll find out that many investors are using leverage for their investments. Now you might be asking whether using leverage is good or bad. The answer to that question, according to Tim Nuding from CFAInstitute.org, is neither. Leverage amplifies both positive and negative outcomes of investment. For one, leverage inclines investors to make debts; and as we all know, debts are liabilities. But, as mentioned moments ago, potential ROI will increase using leverage, which is a good sign for assets to come in your possession. Leveraging your real estate investments is like a balancing act. You need to weigh in both the bad and good outcomes in order to earn a profit or to breakeven at least.

Without further delays, we now begin discussing the risks in real estate leveraging and the certain methods to work your way around them.

Relying on High Appreciation Rates

Appreciation refers to the increase of a real estate property's value over time. Of course, investors prefer placing their investments on properties with high appreciation. If you want to do the same, you can, but you should know that's not entirely practical. For example, you discovered an analysis report showing that the appreciation of a particular rental property increases every year. You want to invest in that property with the assumption that its appreciation will increase once again the following year, which is risky. The value of that property might decrease next year, and your investment will basically become a loss. Previous patterns of a property's appreciation should not be used as a basis in predicting its future value. Many factors can affect the appreciation of a property, which can't be foreseen mostly. So as much as possible, don't get too caught up in a property's appreciation rate. Instead, assess its checklist of aesthetic attributes, such as its size and quality, and other things that make it marketable.

Focusing on the Property and Overlooking the Cash Flow

Focusing on the property management aspects to grow real estate ROIs is an excellent practice. However, such a method might cause you to overlook the cash flow. As a property investor, money should be your primary language rather than tangible assets. If you overlook the cash flow, chances are you won't be able to monitor well where your money will be going in the investment. The solution to this risk is simple enough. Calculate the whereabouts of your cash going into your investment. Map out which expenditure they will be allocated and determine how they'll convert into ROI.

Rushing to Buy the Next Property

Real estate marketing strategies are prompting investors to purchase multiple properties for various advantageous reasons. With the use of leverage as a means of maximizing ROI, investors will likely give several properties a go. You can follow suit if you have the resources, but keep in mind that it's a risky move no doubt. Using leverages for every property you'll be investing in simultaneously means you'll have multiple debts to cover. And if you think about it realistically, not every investment pays off in the end. That said, there's a chance that you'll suffer one or two (or even more) losses out of all your property investments. To avoid that outcome, don't purchase too many properties at once or consecutively. Place your investments one at a time and slowly but surely.

Possible Excessive Payments

Most leverages in real estate investments are made possible by mortgages. If you use a mortgage for leverage, you're at risk of having to pay it excessively per month. Remember that mortgages have regular interest rates. If the value of the property you're investing in decreases, you may have to pay your mortgages using money from your pocket, instead of the property's generated revenue. To make sure that doesn't happen, you need to formulate ways to increase the value of your property. Find potential tenants for it so that you can use revenue from rent bills as payment for your mortgages.

Making Bad Purchases with Small Amounts

Undeniably, each of us wants to obtain something at the lowest possible price, which is good leverage to have. But when it comes to investing in real estate, a cheap property doesn't directly lead to the assurance of ROIs. There's a possibility that a certain property garners minimal interest in the market. In that case, no tenants and clients will be there to generate revenue for you through your property. So to identify whether you'll have ROIs from a cheap property, you must study the trends in the real estate market and look for other properties similar to it.

Choosing a Mortgage

Choosing a mortgage for leverage is certainly a risky approach without a doubt. As mentioned earlier, mortgages must be paid monthly with interest. Should you use a mortgage for leverage, you have to select one that has minimal monthly interest rates while still being able to give you, well, leverage. You need to maintain a practical mind in choosing a mortgage to work things into your favor.

Indulging in real estate transactions can bring out the resourcefulness and cleverness within yourself, especially during negotiations. Finding leverage to come out victorious in your real estate investments is a good example of that. We enthusiastically hope that you've learned useful things in this blog and end up successful in your property investments in the market.