

The Major Renovation ~Does it Pay?



By Brian Madigan LL.B.

What happens if you are in a nice area and you decide to improve your home rather substantially?

Recently, I came across two properties that will illustrate this situation. In 1985, both properties were worth about \$200,000. They were purchased within a few months of one another. They were one block apart and they were the exact same builder's model. They were both constructed in 1965.

The first house was purchased by an elderly couple. They maintained it but did not improve it in any way. As you might imagine, things wore out and deteriorated. By 2007, when it was to be sold, it was essentially in the same condition that it was when they bought it, and not too different from the builder's original finishes in 1965.

The second house was purchased by a young upwardly mobile couple with a family. They wanted more room for the 3 children, so within 2 years of moving in, they added a substantial addition at a cost of \$150,000, a new kitchen at a cost of \$30,000 and a new swimming pool at a cost of \$20,000. And, it looked great when it was sold in 2007.

The first house took two full months to sell. That's about twice the normal period and the second house took 2 days. The first house sold for \$310,000, a \$110,000 increase over its cost, and the second house sold for \$470,000 or \$70,000 over its cost.

The big winner would be the first house: no changes, no improvements, just an increase in real estate values. Without a question, the second house was the nicest house on the street. It was a half million dollar home sitting in a \$300,000 area. And, that was the problem. It was the top end, it was over-improved. Although the costs were there, buyers couldn't rationalize the expense. It was only worth so much, in that particular location.

So, what contributed to its value and what didn't? The bulk size of the addition

provided an increase to the square footage and purchasers were prepared to pay something for this. The new kitchen, as nice as it was, still happened to be 20 years old, and although it was not out of the '60's, nevertheless it would not carry a brand new price to the bottom line. The swimming pool was an excellent addition and was well-landscaped. In any other property, it should carry at least one half of its cost, but here we are already at the top end of the price range, so it adds zero to the bottom line.

Should we make matters worse? If we bring in the cost of money and add the improvements to the mortgage, the additional interest over that 20 years would be substantial. Let's assume for the moment that this couple had \$100,000 saved up and needed to add \$100,000 to the mortgage at a 10% interest rate. As a result, $\$100,000 \times 10\%$ would amount to \$10,000 annually. So, how much interest would this be over 20 years (1987 to 2007)? This would be calculated as $\$10,000$ (per year) \times 20 years = \$200,000.

Now, we have to go back to the sale price. You thought there was a \$70,000 profit. But, this \$200,000 additional cost (that almost no one ever calculates) must be subtracted from the profit. This means an effective \$130,000 loss on the whole deal. This means if you bought a property in 1985 for \$200,000, you lost \$130,000 of that equity. That's just like having \$70,000 in 1985 rather than the \$200,000 that you really did have.

And, you are quite correct, matters would even be worse if you financed that entire \$200,000 renovation over 20 years.

So, what's the moral of the story? You will have to undertake renovations and improvements carefully. If you have the best house on the street, you might lose money bigtime!

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