

A STUDENT'S DILEMMA: RENT OR BUY?

Caitlin Neal and Sabrya Karim wrote this case under the supervision of Professor Mehmet A. Begen solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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It was December 2011, and the end of Christine Scott's first semester of university was in sight. As she looked around her familiar room in Saugeen-Maitland Hall at Western University in London, Ontario, she felt a wave of nervousness about the upcoming decision that she had to make. It was time to decide where she would be living next year and she faced her biggest dilemma yet: should she rent or should she buy?

BACKGROUND

Scott and four of her closest friends had already decided to live together off campus next year, so they began their search to find the perfect house. They were looking for a five-bedroom house with at least two bathrooms, relatively close to campus.

After a busy day of looking at rental properties, Scott called her parents to talk about her options. During the discussion, it was brought up that Scott had some money saved up and, if matched by her parents, it would be enough for a down payment on a house. If there was a house for sale that Scott and her roommates liked, then Scott had the option of purchasing the house and then renting it out to her friends.

Scott was a little bit overwhelmed. If she decided to buy a house, she would be the owner and landlord, in charge of managing the property and setting the rent in order for the purchase to make financial sense. This would be time-consuming and demanding at certain points. If she went through with this decision, however, her parents had agreed that she would be able to keep the profits after selling the house. As Scott thought about her 20s and the cost of both her education and living expenses, as well as future down payments, buying a house and keeping the profits after selling it became more and more appealing.

BUY

After calculating the amount of money she would be able to invest in a house, Scott decided that she would be able to afford a house with a down payment that was less than or equal to \$50,000.¹ Her parents

¹ All currencies are in Canadian dollars unless otherwise stated.

agreed to match her \$25,000 only if she bought a house. Down payments were typically calculated using 20 per cent of the price of the property. Knowing this, Scott and her friends began looking for an appropriate house, which they found just minutes away from the Richmond Gates' entrance to campus (see Exhibit 1).

To prepare to make the necessary calculations, Scott did her research by talking to other homeowners about all of the costs associated with managing a house. If she decided to buy a house, Scott knew that she would be able to get a three-year closed mortgage with an interest rate of 3.95 per cent with a 20 per cent down payment. The mortgage would be amortized monthly over 25 years. However, because it was a closed mortgage, she would not be able to sell the house and pay off the mortgage until the expiry of the three-year term. Exhibit 2 shows the amortization table the bank provided her based on the house she had chosen.

BUYING/SELLING COSTS

Property Tax, Insurance and Maintenance

Annual property tax in London was calculated using 1.4427 per cent of the value of the house from the previous year. This amount would be paid in installments throughout the year. Insurance would be \$1,200 annually and additional maintenance costs over the full three-year period would be approximately \$6,000.

Utilities

After speaking with many different people, Scott came up with average utility costs per month. Hydro and gas would be \$100 and \$30 respectively, with an increase of 50 per cent in the winter months (November to February) and a decrease of 50 per cent in the summer months (May to August) when no one would be occupying the house. As well, it would be \$120 every three months for the rental of the water heater. Scott also knew that if she charged a gross rental price that included hydro, gas, and the water heater, her friends would most likely consume 20 per cent more because they would be unaware of the cost.

Internet and Cable

The current Rogers student deal that would include everything Scott and her roommates would need for Internet and television would cost them \$70 monthly for eight months.

RENT

While searching for places to live, Scott and her roommates found two rental properties that they were interested in. In one, the landlord paid for utilities (inclusive) and, in the other, she was responsible for paying the utilities (non-inclusive). They chose these two houses because they did not want to pay more than \$550 (including utilities). All the information pertaining to these two places can be found in Exhibit 3. Utilities, Internet and television costs would be similar to the ones outlined above.

OTHER

Scott knew that any money she had not spent on rent would earn 1 per cent sitting in her bank account. She also knew there were other options such as stocks and bonds, but she did not have the time to manage an investment account, especially considering that she needed to withdraw money frequently.

Historically, house prices in London had been increasing by 2 per cent annually. When she eventually sold the property, the real estate agent would likely charge a 5 per cent commission fee of the final price of the property.

GOING FORWARD

Scott sat down at her desk to figure out what option would make the most sense financially. If she went the route of purchasing a house, she would need to figure out what she should charge as rent, and whether or not that price should include utilities. Another consideration was the time and effort that she would need to contribute in order to manage the house, including small maintenance issues, paying bills, doing her taxes, and any other miscellaneous issues that would come up. Would those costs outweigh any financial benefit? Being in her second year in university, would managing a house be so overwhelming that it would hinder her performance academically? And if she and her friends went the route of renting a house, should they choose a property where the utilities were included in the rental price, or not? It was time to start crunching numbers.

EXHIBIT 1: HOUSE LISTING



5 Bedrooms, 3 Bathrooms. Beautiful house in a quiet neighbourhood, less than 10-minute walk to the centre of campus. All appliances included. Newly renovated. Available to be converted into a rental property.

Source: Sample listing obtained by online search

EXHIBIT 2: AMORTIZATION TABLE OF MORTGAGE

Cost of House	239,000
Downpayment	20%
Original Principal	47,800
Annual Interest Rate	3.95%
Loan Term (Years)	25
Payments per Year	12
Monthly Payment	-\$1,003.95
Annual Payment	-\$12,047.44

Year	Interest	Principal	Balance
0			\$191,200.00
1	\$7,470.12	\$4,577.31	\$186,622.69
2	\$7,286.01	\$4,761.43	\$181,861.26
3	\$7,094.49	\$4,952.95	\$176,908.31
4	\$6,895.27	\$5,152.17	\$171,756.15
5	\$6,688.03	\$5,359.40	\$166,396.74
6	\$6,472.46	\$5,574.98	\$160,821.77
7	\$6,248.22	\$5,799.22	\$155,022.55
8	\$6,014.96	\$6,032.48	\$148,990.07
9	\$5,772.31	\$6,275.12	\$142,714.94
10	\$5,519.91	\$6,527.53	\$136,187.41
11	\$5,257.35	\$6,790.09	\$129,397.33
12	\$4,984.23	\$7,063.20	\$122,334.12
13	\$4,700.13	\$7,347.31	\$114,986.82
14	\$4,404.60	\$7,642.84	\$107,343.98
15	\$4,097.18	\$7,950.26	\$99,393.72
16	\$3,777.40	\$8,270.04	\$91,123.68
17	\$3,444.75	\$8,602.69	\$82,521.00
18	\$3,098.72	\$8,948.71	\$73,572.29
19	\$2,738.78	\$9,308.66	\$64,263.63
20	\$2,364.36	\$9,683.08	\$54,580.56
21	\$1,974.88	\$10,072.56	\$44,508.00
22	\$1,569.73	\$10,477.71	\$34,030.29
23	\$1,148.28	\$10,899.15	\$23,131.13
24	\$709.88	\$11,337.55	\$11,793.58
25	\$253.85	\$11,793.58	\$0.00

Source: Case writers' sample calculation.

EXHIBIT 3: RENTAL PROPERTIES

\$435/Bedroom, Non-Inclusive
(1.5 Km from campus)

**3 Storey Condo near UWO!**

Bedrooms: 5
Bathrooms: 3.5

Features

- ✓ No Pets
- ✓ Dishwasher
- ✓ Parking
- ✓ Fridge/Stove
- ✓ Microwave
- ✓ Balcony
- ✓ Washer/Dryer
- ✓ A/C

Utilities

- ✓ Plus Heat
- ✓ Plus Hydro
- ✓ Plus Water

This is an immaculate 3-level townhouse with an open concept and spacious living room. Close to Masonville Mall and UWO. Bus route right outside complex.

\$510/Bedroom, Inclusive
(0.5 Km from campus)

**2 minute walk to Western campus!**

Bedrooms: 5
Bathrooms: 2
Bathrooms: 3.5

Features

- ✓ Dishwasher
- ✓ Parking
- ✓ Fridge/Stove
- ✓ Balcony
- ✓ Washer/Dryer
- ✓ A/C

Utilities

- ✓ Heat Incl
- ✓ Hydro Incl
- ✓ Water Incl

Great 5-bedroom unit in a new building — doesn't get any closer to campus than this. Hardwood floors, 5 equal-sized bedrooms and open kitchen concept.

Source: Sample listings obtained by online search.