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Cash Flow Analysis of Rental Homes #66400

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2016

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CASH FLOW ANALYSIS OF RENTAL HOUSES

Student Handout

Mike Nelson, GRI©, MPM©, RMP©

Excalibur Homes, LLC CRMC©

Why Do I Need to Know Cash Flow Analysis?

- Become the ____________ not the “gopher” (Go for)
- Advise your client more effectively
- Increase brokerage transactions
- Build Investor _____________

The 4 Ingredients of the Analysis

- _________________
- Loan Amortization
- _____________________
- ________________

Cash Flow Equation

From top to bottom it is calculated as:
Potential Gross Income – Vacancy & Bad Debt = Effective Gross Income
Effective Gross Income – Operating Expenses = Net Operating Income
Net Operating Income –Debt Service = Before Tax Cash Flow
+/-Tax Savings = After Tax Cash Flow

Operating Expenses are specifically those cash outlays that would be expenses taken off your tax return as opposed to cash outflows that may turn into another asset to be depreciated. HOV Fee would be an example of an Operating Expense.

Loan Amortization

- Every payment on a fully amortizing loan, part of the payment is repaying the principal amount which is reducing the amount of the debt which increases the owners equity.

Tax Savings

- Tax Savings are the dollars that the investor DOES NOT send to the IRS or State that they would have had to send if they did not own the property.
- The **marginal tax rate** is the rate of tax that the taxpayer pays for the next dollar earned.
- The **effective tax rate** for individuals is the average rate at which their earned income is taxed.

Terms Defined:

- **Appreciation** is the term used to describe the increase in the value over time

- **Accumulated Losses** are those losses an investor is not able to deduct from his/her tax return in the year that the losses occurred.

- **Amortization** from the Latin "Amort" which means to kill, die or diminish.

- **Basis** The un-depreciated value of the asset
    - Original Basis (is usually your cost to acquire the asset plus any Rehab or capital improvements)
    - Depreciable Basis (Buildings & Improvements, not land)
    - Adjusted Basis is the result of increasing or decreasing your original basis to take account of certain events.

  Increases to basis include but are not limited to:
    - The cost of improvements having a useful life of more than a year
    - Assessments for local improvements
    - Sales tax that is not deducted
    - The cost of extending utilities lines to your property
    - Legal fees incurred in defending or perfecting title to property
    - Costs of obtaining a zoning change for property

  Decreases to basis include but are not limited to:
    - Depreciation, amortization, and depletion deductions
    - Nontaxable corporate distributions
    - Insurance reimbursements for casualty and theft losses
        - Easements
        - Rebates from the manufacturer or seller

- **Before Tax Cash Flow** is the flow of money through a property, in and out. It is all the money, without regard to deductibility for tax purposes. Thus, a tax return may show losses, while actual cash flow might show profits, or vice versa.

- **CapEx** (Capital Expenses) – add to the book value of the property and are depreciated or amortized. They are not an expense. The typical small real estate investor would choose to expense everything they can to reduce their tax liability so they can keep more cash in their account, paying less to the IRS. The Institutional investor does just the opposite. They will capitalize everything possible so that the "expenses" appear lower and "profit" and "book value" are higher which makes them look good to their clients.

- **Capital Gain** A term used for income tax purposes that represents the gain realized from the sale of an asset less the purchase price. The NET sales price less the original purchase price (adjusted for any capital improvements to the property) is the capital gain

- **Capitalization Rate** ("Cap Rate") is a ratio used to compare properties with different valuations, and to also place a value on a property based on the income it generates. The Cap Rate is computed by taking the rental net operating income (NOI) and dividing it by the property's fair market value (FMV). The higher the Capitalization Rate, the better.

- **Cash on Cash Rate** is the ratio of annual before-tax cash flow to the total amount of cash invested, expressed as a percentage.

- **Debt Service** the sum of principal and interest payments for any loans on the property.

- **Effective Gross Income** is the anticipated income from all operations of the real property after an allowance is made for a vacancy and collection losses. Effective gross income includes items constituting other income, i.e., income generated from the operation of the real property that is not derived from space rental

- **Financial Management Rate of Return** The FMRR allows you to enter a different rate that is applied to the property's annual cash flow. This rate used is generally a bank or savings rate. Using the FMRR will more closely mimic reality as you rarely are able to reinvest the cash flow at the same rate of return as determined by the IRR formula.
- The ***finance rate*** is the annual interest rate that you would pay to cover any negative cash flows incurred during the life of the investment.
- The ***reinvestment rate*** is the interest rate that you would earn on cash that the investment generates during its life.

- **Gross Rent Multiplier** The GRM is calculated by dividing the fair market value of the property by the monthly gross rental income.

- **Gross Yield** The ratio of the total annual rent divided by the purchase price.

- **Internal Rate of Return** IRR is the rate needed to convert (or discount) the future uneven cash flow to your initial investment or down payment. Another way to look at it is the internal rate of return (IRR) is the discount rate at which the "net" present value of future cash flows is zero (discounted future cash flows = starting investment amount).

The IRR is the tool a real property investor can use to evaluate their true return on investment considering all factors of the property including cash flow, loan amortization, AND appreciation. IRR is the rate needed to convert or discount the future uneven cash flow to your initial investment or down payment

- **Modified Internal Rate of Return** - While the internal rate of return (IRR) assumes the cash flows from a project are reinvested at the IRR, the Modified IRR assumes that positive cash flows are reinvested at the firm's cost of capital, and the initial outlays are financed at the firm's financing cost. Therefore, MIRR more accurately reflects the cost and profitability of a project. Similar to FMRR but it takes amounts needed to fund negative cash flows back to the beginning of the investment rather than to the closest prior positive cash flows which is the FMRR technique.

- **Net Operating Income** equals all revenue from the property minus all reasonably necessary operating expenses (not Capital Expenditures). Operating expenses are those required to run and maintain the building and its grounds, such as insurance, property management fees, utilities, property taxes, repairs and janitorial fees. NOI is a before-tax figure; it also excludes principal and interest payments on loans, capital expenditures, depreciation and amortization.

- **OpEx (Operating Expenses)** is an ongoing cost for running the property but they do not add to the basis of the asset.

- **Potential Gross Income** (or Gross Potential Income) is the maximum market rent that can be derived from 100% occupancy and 100% collection of rents over the course of a financial period

- **Vacancy & Bad Debt** (Credit Loss) in real estate investing is the amount of money or percentage of income that is estimated to not be realized due to non-payment of rents and vacant units.

Cash Flow Analysis Sample Problems

<u>Assumptions For Every House –</u>

Your client wants to buy another rental house and wants you to help them select the best option. Your client has $60,000 in cash available to buy the property but she only wants to invest as little of that as will be required.

- Conventional lenders are willing to loan 70% of the price of the house at 4.25% over a 30 year amortization. If available, your client would prefer owner financing.
- Your client's marginal tax bracket is 25%.
- You expect that over the next 5 years inflation will increase your rents and operating expenses at a rate of 3% per year and the property will appreciate at a rate of 4% per year.
- Any Gross Yield, Gross Rent Multiplier, or Cap Rates should be calculated based on the total amount invested, i.e. purchase price plus Rehab plus costs to acquire the property and close the sale.
- Since your client will need to have utilities on at least some of the time while the property is vacant, budget $50 per year for utilities.
- Assume that it will cost your client 10% of the sales price when they sell to cover commissions and closing costs.
- Depreciation – For the purposes of this exercise, for each house assume that 20% of the purchase price is land, that your client will not be using any component depreciation methods, so 80% of the price, plus 100% of any Rehab, will be depreciated over the standard 27.5 year schedule. Any initial Rehab you expect to do with the acquisition would be part of the amount invested. For example, a $150,000 purchase price plus a $5000 Rehab would be calculated as $150,000 times 80% (80 of purchase price is depreciable = $120,000) plus the $5000 Rehab = $125,000 in depreciable basis. That $125,000 divided by 27.5 years would mean an annual depreciation deduction of $4545. Round all calculations to the nearest whole dollar using IRS rounding technique – 49 cents rounds down and 50 cents rounds up. Amounts spent for inspections and appraisals will not be part of the depreciable basis. They will be expensed.
- In this exercise, to calculate After Tax Cash Flow, use the Net Operating Income and deduct the mortgage interest and the depreciation deduction to calculate the taxable income. Then multiply the investor's marginal tax bracket by the amount of taxable income to see if the investor will pay additional tax or save money on their taxes (tax savings). If the taxable income is negative, then the amount calculated will be a tax savings.

Property 1

123 Main Street is a 3 BR 2 BA ranch that can be bought for $150,000. It will rent for $1100 per month according to your CMA. You project that, based on the area, the average tenant will stay 36 months and every 3 years you expect to lose 2 month's rent due to vacancy and $1100 due to delinquency or bad debt. The house is in an HOA that has a pool & tennis court. The HOA fee is $200 per year. The owner has 2 kids in college and she is thinking about selling the house in order to pay their tuition. The property taxes are $1000 per year. The Seller has appealed the tax assessment but the County has not lowered his bill yet. Insurance will cost another $660 per year. Your client's insurance agent was telling her he could reduce her insurance premium by $90 per year if she increases her deductible to $2500 but she hasn't done that yet. Based on the age and condition of the house, you expect to spend $1400 per year on maintenance and repair. The house is 10 years old and there is no Rehab required. Your fees to the owner for leasing and managing the property should average $1426 per year. You expect to make another $240 per year from the tenant. The seller has a 1st mortgage in the amount of $96,000 at 4.82% interest payable over 30 years. His monthly payments are $669.04 for P & I and $820 per month for PITI (no MIP). While the seller has agreed to pay most of the closing costs for the new loan, your client will need to spend $500 on an inspection and $500 for an appraisal.

(Calculate and fill in the shaded cells. Tax calculations are for familiarization only. Do not calculate your client's taxes in your business. Only recommend to your client issues which they should review with their tax advisor.)

Potential Gross Income (PGI)				**Gross Yield** (PGI/Total Cost)
- Vacancy & Bad Debt				**Gross Rent Multiplier** (Total Cost/Rent)
= Effective Gross Income				
(Less all Operating Expenses)				
-Property Taxes				
-Insurance				
-Maintenance & Repairs				
-Management Fees				
-HOA Fees				
-Utilities				
-Other Expenses				
Sub-total of all Expenses				
=Net Operating Income (NOI)				**Cap Rate** (NOI/Total Cost)
-Debt Service				
=Before Tax Cash Flow (BTCF)				**Cash on Cash** (BTCF/Total Cash Invested)
-Taxes or (Tax Savings)				
After Tax Cash Flow				
(Taxable Income Calculation)				
Net Operating Income				From above
-Mortgage Interest				From Loan Info table
-Depreciation				Review General Assumptions
=Taxable Income or (Loss)				
X Investor's Marginal Tax Bracket				
=Taxes or (Tax Savings)				Taxes reduce income, tax savings increase income

Property 1

LOAN INFO	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Interest		$4428	$4352	$4272	$4188	$4101
Principle		$1770	$1847	$1927	$2010	$2098
Unpaid loan balance						$95348

Potential Gross Income = Monthly Rent X 12 (Annual PGI)

Gross Yield = Annual PGI ÷ Total Cost to Purchase

Gross Rent Multiplier = Total Cost to Purchase ÷ rent (monthly or annual)

Cap Rate (Capitalization Rate) = Net Operating Income ÷ Total Cost to Purchase

Cash on Cash Return = Before Tax Cash Flow ÷ Total Cash Invested

Taxable Income or Loss = Net Operating Income – Mortgage interest and Depreciation

Taxes or (Tax Savings) = Taxable Income or Loss x Investor's Marginal Tax Rate

IRR Practice Work Sheet

Property 1	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
PGI						
-V & DB						
EGI						
-OE						
NOI						
-Debt Service						
BTCF						
Appreciated Value	$150,000					
Selling Expenses						
Loan Payoff						
Net Sales Proceeds						
Initial Investment (Year 0) BTCF + Sale Proceeds (Yr 1-5)	$ (46,000)					
IRR						Instructor

Property 2

456 Maple Ave. is a 3 BR 2 BA ranch that can be purchased for $145,000. The Seller has no cash available for repairs so they are selling the house "as is". There are a few fist size holes in the walls and the carpet needs to be replaced. You estimate your client would need to spend $3000 to make the house rent ready after closing. Your CMA indicates the house will rent for $1050 per month. This house is in a highly sought after school district. Your client will spend $500 for an appraisal and $500 for a home inspection if they buy this house. You project that the average tenant will stay 36 months and every 3 years you expect to lose 1.5 month's rent due to vacancy and $525 due to delinquency or bad debt. The Seller is getting a divorce and she is thinking about selling the house rather than trying to buy out her husband's share. The property taxes are $950 per year. Insurance will cost another $620 per year. Based on the age and condition of the house, you expect to spend $1200 per year on maintenance and repair. Your fees to lease and manage the property should average $1360 per year. You expect to earn another $180 per year on fees paid to you by the tenant. There is no HOA so there is no pool or tennis available in the community. The Seller has a 1st mortgage in the amount of $138,000 at 4.75% interest payable over 30 years. His monthly payments are $719.87 for P & I and $870 per month for PITI. The seller has informed you that a developer is interested in building a Walmart less than 1 mile away and there is a re-zoning hearing scheduled for next month.

(Calculate and fill in the shaded cells. Tax calculations are for familiarization only. Do not calculate your client's taxes in your business. Only recommend to your client issues which they should review with their tax advisor.)

Potential Gross Income (PGI)				**Gross Yield** (PGI/Total Cost)
- Vacancy & Bad Debt				**Gross Rent Multiplier** (Total Cost/Rent)
= Effective Gross Income				
(Less all Operating Expenses)				
-Property Taxes				
-Insurance				
-Maintenance & Repairs				
-Management Fees				
-HOA Fees				
-Utilities				
-Other Expenses				
Sub-total of all Expenses				
=Net Operating Income (NOI)				**Cap Rate** (NOI/Total Cost)
-Debt Service				
=Before Tax Cash Flow (BTCF)				**Cash on Cash** (BTCF/Total Cash Invested)
-Taxes or (Tax Savings)				
After Tax Cash Flow				
(Taxable Income Calculation)				
Net Operating Income				From above
-Mortgage Interest				From Loan Info table
-Depreciation				Review General Assumptions
=Taxable Income or (Loss)				
X Investor's Marginal Tax Bracket				
=Taxes or (Tax Savings)				Taxes reduce income, tax savings increase income

Property 2

LOAN INFO	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Interest		$4281	$4207	$4129	$4048	$3964
Principle		$1711	$1785	$1863	$1943	$2028
Unpaid loan balance						$92170

Potential Gross Income = Monthly Rent X 12 (Annual PGI)

Gross Yield = Annual PGI ÷ Total Cost to Purchase

Gross Rent Multiplier = Total Cost to Purchase ÷ rent (monthly or annual)

Cap Rate (Capitalization Rate) = Net Operating Income ÷ Total Cost to Purchase

Cash on Cash Return = Before Tax Cash Flow ÷ Total Cash Invested

Taxable Income or Loss = Net Operating Income – Mortgage interest and Depreciation

Taxes or (Tax Savings) = Taxable Income or Loss x Investor's Marginal Tax Rate

Property 2	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
PGI						
-V & DB						
EGI						
-OE						
NOI						
-Debt Service						
BTCF						
Appreciated Value	$148,000					
Selling Expenses						
Loan Payoff						
Net Sales Proceeds						
Initial Investment (Year 0) BTCF + Sale Proceeds (Yr 1-5)	$ (47,500)					
IRR						Instructor

Property 3

789 10th Street is a 3 BR 2 BA split level that can be purchased for $155,000. The Seller owns the property free and clear and is offering to finance the sale. Your client would only need to put 20% down and the balance would be financed at 5% over 30 years with a balloon payment due after 5 years. While your client still plans to spend $500 on a home inspection, they will not need to pay for an appraisal. This house has been a rental for years and it needs a lot of cosmetic work to get it back into rent ready condition. You estimate your client would need to spend $5000 to make the house rent ready after closing. Your CMA indicates the house will rent for $1250 per month after you make all the cosmetic improvements. This house is in the same highly sought after school district. In addition to the pool and tennis available from the HOA, there is a county park within walking distance that includes playgrounds, ball fields, walking trails, and mountain biking trails. You project that the average tenant will stay 36 months and every 3 years you expect to lose 1 month's rent due to vacancy and $625 due to delinquency or bad debt. The Seller is getting a divorce and she is thinking about selling the house rather than trying to buy out her husband's share. The property taxes are $1050 per year. Insurance will cost another $700 per year. Based on the age and condition of the house after the $5000 Rehab, you expect to spend $1000 per year on maintenance and repair. Your fees to lease and manage the property should average $1650 per year. You expect to earn another $210 per year on fees paid to you by the tenant. The HOA costs $275 per year.

(Calculate and fill in the shaded cells. Tax calculations are for familiarization only. Do not calculate your client's taxes in your business. Only recommend to your client issues which they should review with their tax advisor.)

Potential Gross Income (PGI)				**Gross Yield** (PGI/Total Cost)
- Vacancy & Bad Debt				**Gross Rent Multiplier** (Total Cost/Rent)
= Effective Gross Income				
(Less all Operating Expenses)				
-Property Taxes				
-Insurance				
-Maintenance & Repairs				
-Management Fees				
-HOA Fees				
-Utilities				
-Other Expenses				
Sub-total of all Expenses				
=Net Operating Income (NOI)				**Cap Rate** (NOI/Total Cost)
-Debt Service				
=Before Tax Cash Flow (BTCF)				**Cash on Cash** (BTCF/Total Cash Invested)
-Taxes or (Tax Savings)				
After Tax Cash Flow				
(Taxable Income Calculation)				
Net Operating Income				From above
-Mortgage Interest				From Loan Info table
-Depreciation				Review General Assumptions
=Taxable Income or (Loss)				
X Investor's Marginal Tax Bracket				
=Taxes or (Tax Savings)				Taxes reduce income, tax savings increase income

Property 3

LOAN INFO	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Interest		$6158	$6065	$5966	$5863	$5754
Principle		$1829	$1923	$2021	$2125	$2234
Unpaid loan balance						$113868

Potential Gross Income = Monthly Rent X 12 (Annual PGI)

Gross Yield = Annual PGI ÷ Total Cost to Purchase

Gross Rent Multiplier = Total Cost to Purchase ÷ rent (monthly or annual)

Cap Rate (Capitalization Rate) = Net Operating Income ÷ Total Cost to Purchase

Cash on Cash Return = Before Tax Cash Flow ÷ Total Cash Invested

Taxable Income or Loss = Net Operating Income – Mortgage interest and Depreciation

Taxes or (Tax Savings) = Taxable Income or Loss x Investor's Marginal Tax Rate

Property 3	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
PGI						
-V & DB						
EGI						
-OE						
NOI						
-Debt Service						
BTCF						
Appreciated Value	$160,000					
Selling Expenses						
Loan Payoff						
Net Sales Proceeds						
Initial Investment (Year 0) BTCF + Sale Proceeds (Yr 1-5)	$ (36,500)					
IRR						

"I am not qualified to give you tax advice, but these are some issues that you should consider and discuss with your tax advisor"

Techniques to Maximize Potential Gross Income & Reduce Vacancy Losses

- Perform a CMA.
  - _____ the property correctly.
  - If the property is over-priced, then it sits empty longer.
  - If the property is underpriced, then you are giving away money.

- Use effective/creative marketing techniques.
- Respond to inquiries quickly.
- Make sure unit shows well.

If incentives are necessary, use incentives with _______________.
- Consider accepting pets.
- If you have to negotiate, try to add value to the unit (W/D, microwave, fence) before just giving away rent.

Reducing Delinquency Losses
- ALWAYS _______ Your Tenants-Comply with Fair Housing Laws
- Evict or Negotiate- Don't wait on promises to pay later

Calculating Loss due to Vacancy as a % of Gross Annual Income

- The calculation, and consideration, is that "vacancy rate" is not the same as income lost due to vacancy.
- This calculation is measuring the amount of dollars lost due to vacancy.
- As you perform this function month after month, you will have a good idea about how much money, as a percent, properties you manage will lose due to vacancy.
- Correspondingly, it is important that you be accurate here because you will be expected to deliver these numbers.

Calculating Loss Due to Delinquency as a % of Gross Annual Income

Total Unpaid Rent
(after Sec Dep Applied)
÷
Total Rent Roll

Management's Impact on Operating Expenses
- Make sure your client understands that your recommendations are based on trying to maximize their return on investment.
- Maintenance vs. Repairs
  - Spending some money now, like an exterior paint job, will save money later by not having to replace rotten wood, then performing an exterior paint job.
  - Make sure you are using reputable and insured vendors.
- Repair vs. Replace:

- HVAC filter changes, exterior caulk and paint, weed control, and gutter cleaning are examples of maintenance. Done on time these services reduce repair costs.
- A "no pet" policy eliminates as much as 80% their potential tenants. Correspondingly, make pet recommendations based on what is at risk. For instance, if the carpet is brand new, you may charge a much higher pet deposit. If the carpet is already 5 years old then you are not risking as much to accept the pet since the carpet is coming due to be replaced anyway.
- KNOW THE LAW
  - Be familiar with local, state and federal laws as well as community association rules & restrictions as well as all ethical considerations.

Estimate for Annual M &R Expenses

Total $ spent on Maintenance/Repairs
÷
Total properties/units under management
=
Average per property/unit for that period

Appreciate (your Clients Position)

Ask questions, then _____ up and listen.

Consideration/Alternatives for your client to review with their tax advisor:

- **Owner Occupant vs. Investor sale –** If your client has the option to sell as an owner occupant, because they have lived in the house for 2 of the past 5 years, they might save on capital gains taxes if they sell within the required time frame.
  - Would there be a gain on the sale?
  - Has the owner taken any depreciation deductions already?
  - Does the client have any deferred losses that could be used to offset a capital gain?
- **Investor Sale vs. Tax Deferred Exchange –** If your client is not opposed to owning rental property, then they might use a 1031 Exchange to move from an older house to a newer house, a poor performing house to a better performing house, a rental house to a triple net commercial lease, or move their equity from one property to more properties, etc. In addition to the questions above, the client might want to consider:
  - How much equity do they have?
  - If sold, how much would they owe in taxes (federal & state)?
  - What do they plan to do with the cash once the property is sold? If they have a lot of equity, and need cash for some other purpose, they might still use the 1031 to move to a different property, then refinance that property to pull cash out for the other purchase/need.
- **Foreclosures –** A foreclosure is still a "sale" as far as the IRS is concerned. If the client is considering letting the house go back to the vendor, they might want to review the tax obligations, such as the recapture of depreciation taken, with their tax advisor. If the property is sold for less than the outstanding loan amount, then the owner may also face taxes related to additional income as a result of "debt relief".

Georgia Association REALTORS® - Partners in Education

Student Course / Instructor Evaluation

Course Name ______________________________

Instructor _________________________________

Date ______________________________________

PLEASE FILL IN THE BUBBLES COMPLETELY SO ANSWERS ARE SCANABLE.

Please do NOT use check marks, x's or any other type of mark.

The instructor encouraged my participation through questions and answers or exercises.

- ◯ Strongly Disagree
- ◯ Disagree
- ◯ Neutral
- ◯ Agree
- ◯ Strongly Agree

The instructor presented ideas clearly and made the subject matter interesting.

- ◯ Strongly Disagree
- ◯ Disagree
- ◯ Neutral
- ◯ Agree
- ◯ Strongly Agree

The use of the outline / handouts for study and / or reference was helpful.

- ◯ Strongly Disagree
- ◯ Disagree
- ◯ Neutral
- ◯ Agree
- ◯ Strongly Agree

The topic is relevant / helpful to my real estate activities.

- ◯ Strongly Disagree
- ◯ Disagree
- ◯ Neutral
- ◯ Agree
- ◯ Strongly Agree

I would want this instructor back.

- ◯ Strongly Disagree
- ◯ Disagree
- ◯ Neutral
- ◯ Agree
- ◯ Strongly Agree

Additional Comments:

Thank you for your input. (Revised 5-2017)

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