# Investment Real Estate:
# Turning the Key to Wealth™

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# Investment Real Estate: Turning the Key to Wealth

## Financial Intelligence

"Money alone is not wealth. ________________________________ is wealth." – Robert Kiyosaki

o "The greatest threat to the U.S. economy: ____________________________ ."

o Learners are earners: (recommended reading)

• Secrets of the Millionaire Mind, T. Harv Eker
• Stop Acting Rich and Start Living Like a Millionaire, Dr. Thomas J. Stanley
• Cash Flow Quadrant, Robert Kiyosaki

What is the difference between cost, price, value, investment and expense?

________________ The time and money it takes to produce a good or service.

________________ The money a seller asks for a good or service.

________________ What a good or service will do for a buyer relative to the price being asked.

Benefits

1. ______________________________________________

2. ______________________________________________

3. ______________________________________________

4. ______________________________________________

**INCOME, EXPENSE AND FINANCIAL ANALYSIS**

A. Income analysis

1. Potential gross income **(PGI)**

*Total income at full occupancy and before operating expenses are deducted. Includes income from rent, vending machines, washers and dryers, garage fees, etc.*

| |
|---|
| Example: A four-unit apartment building has two units that rent at \$800 each and two units that rent at \$700 each. What is the annual potential gross income? |

2. Vacancy and collection loss **(VAC)**

*Loss of income due to vacancy and nonpayment of rent.*

| |
|---|
| Example: The owner of the above-mentioned building has concluded, based on past experience, that a four-unit apartment building will have an annual vacancy and collection loss of 5%. If the property has a potential gross income of \$36,000, what would the vacancy and collection loss be? |

3. Effective gross income **(EGI)** / gross operating income

*Amount of income remaining after adjusting for vacancy and collection loss. (Potential gross income less vacancy and collection loss = effective gross income)*

**Formula:** **PGI – VAC = EGI**

| |
|---|
| Example: What is the annual gross effective income for the above-mentioned four-unit apartment building? |

B. Expense analysis

1. Operating expenses **(OPEX)**

*Expenses incurred to maintain the property, including replacement reserve*

a. Fixed expenses: do not vary with occupancy

Examples: property taxes, casualty insurance

b. Variable expenses: vary depending on level of occupancy

Examples: utilities, garbage removal, supplies, management fees

c. Other costs associated with investment real estate but NOT included in operating expenses:

i. ______________________________

ii. ______________________________

iii. ______________________________

iv. ______________________________

2. Replacement reserve (reserve for replacement)
*Money set aside to replace certain items in the future, such as kitchen appliances, furniture, roof replacement, carpeting, heating system, laundry equipment. Replacement reserve is included in operating expenses.*

3. Operating expense ratio **(OER)**

*Operating expenses may be expressed as a percentage of the gross effective income. This is known as the operating expense ratio. (Operating expenses ÷ gross effective income = operating expense ratio)*

**Formula:** $\dfrac{\textbf{OPEX}}{\textbf{EGI}} = \textbf{OER}$

| |
|---|
| Example: An income producing property has annual operating expenses of $12,200 and an effective gross income of $34,200. What is the operating expense ratio? |

4. Net operating income **(NOI)**

*The amount of income that remains after deducting operating expenses from the effective gross income. (Effective gross income* *<u>minus</u>* *operating expenses = net operating income)*

**Formula:** **EGI – OPEX = NOI**

| |
|---|
| Example: An apartment building has an effective gross rent of $34,200 and operating expenses of $12,200. What is the property's net operating income? |

C. Cash flow analysis

1. Debt service **(DS)**

The amount of money required to make periodic payments of principal and interest on a mortgage. Debt service is not considered an operating expense.

2. Cash flow before taxes **(CFBT)**

The amount of income that remains after debt service has been paid on investment real estate. (Cash flow before taxes = net operating income less debt service)

**Formula:** **CFBT = NOI – DS**

| |
|---|
| Example: A property has monthly debt service of $1,400 and an annual net operating income of $22,200. What is the cash flow before taxes? |

**CASE STUDY: SINGLE FAMILY RENTAL HOME**

| | | |
|---|---|---|
| Price: | $130,000 | |
| Down payment: | $18,000 | |
| Loan amount: | $112,000 | @ 9% = $900 / month P&I |
| Annual rent: | $15,600 | (1300 / mo.) |
| Vacancy: | 5% | |
| Operating expenses: | $2,960 | |
| Land value: | $30,000 | |
| Personal property: | $10,000 | |
| Building value: | $90,000 | |
| First year's interest: | $10,049 | |
| Land improvements: | $7,000 | |
| Appreciation: | 3% | |
| Tax bracket: | 35% | state and federal combined |

## Analysis Worksheet

### #1. Cash Flow Before Tax

Potential Gross Income ____________________

*Minus:* Vacancy ____________________

*Equals:* Effective Gross Income ____________________

*Minus*: Expenses ____________________

*Equals:* Net Operating Income ____________________

*Minus:* Annual Debt Service ____________________

*Equals*: Cash Flow Before Tax ____________________

### #2. Tax Savings or Tax Liability

Net Operating Income ____________________

*Minus:* Interest ____________________

*Minus:* Depreciation ____________________

*Equals:* Taxable Income ______________________

*Multiply by Investor's Tax bracket:* ______________________

*Equals:* Taxes Saved or (Paid) ______________________

**After Tax Cash Flow**

Before Tax Cash Flow ______________________

*Plus:* Taxes Saved or (Paid) ______________________

**#3. Principal Reduction**

Annual Debt Service ______________________

*Less:* Interest ______________________

*Equals:* Principal Reduction ______________________

**#4. Appreciation**

Initial Property Value ______________________

*Times:* Annual Appreciation Estimate ______________________

*Equals:* Estimated Appreciation ______________________

**Total Benefits**

Cash Flow Before Tax ______________________

Tax Savings ______________________

Principal Reduction ______________________

Appreciation ______________________

**Total Benefits** ______________________

***Divided by:* Investment** ______________________

**Equals Return on Investment** ______________________

**PASSIVE LOSS RULES - THREE FORMS OF INCOME**

1. Active

2. Portfolio

3. Passive

$25,000 rule

October 1993 legislation – real estate professional

At least _______________ of your income must be earned through _______________ related activities, AND you must work at least _______________ hours per year in _______________ related activities. ALSO, you must be an _______________ contractor, not an _______________. Then no gate / limit. Note: only _______________ spouse must qualify as a real estate professional for _______________ to claim this income exclusion.

**SELLING AN INVESTMENT PROPERTY**

**Two formulas needed:**

| Capital gain formula | | Adjusted basis formula | |
|---|---|---|---|
| Sale price | _______________ | Purchase price | _______________ |
| Minus: costs of sale | _______________ | Plus: acquisition costs | _______________ |
| Minus: adjusted basis | _______________ | Plus: capital improvements | _______________ |
| Equals: capital gain | _______________ | Minus: depreciation | _______________ |
| | | Equals: adjusted basis | _______ |

| Depreciation gain | | Total gain | | Market gain |
|---|---|---|---|---|
| _______________ | + | _______________ | + | _______________ |
| x 25% | | x State tax 5% | | x 15% / 5% |
| _______________ | | _______________ | | _______________ |


## ACTION/RESOURCES

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________