CASH FLOW ANALYSIS OF RENTAL HOMES

(Student Handout)

Terms Defined:

- **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.

- **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

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

- **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.

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

- **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.

- **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).

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

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

- **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.

- **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.

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

- **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

- **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.