Georgia Association of REALTORS®

EXPEDITION: EXCELLENCE

2012 Inaugural Meeting
Grand Hotel Marriott Resort, Golf Club & Spa
Point Clear, Alabama • February 8-11

Education Session H

How to Work with Investment Property SELLERS

GREC Course Code #62125

Tom Lundstedt

Thursday, February 9, 2012

You cannot receive Georgia C.E. credit for this course if you have taken it in the last 366 days.

Due to seating capacities dictated by local fire code ordinances, seating for all education sessions will be based on a first come-first serve basis. GAR will not be allowed to have attendees sitting on the floor or standing up once the room's seating is full.

In order to foster a spirit of camaraderie and to avoid the appearance of recruitment, no nametags or clothing with a company logo will be allowed in the education courses. Should an attendee have one on at the time of entering an education course, the facilitators will kindly ask you to remove the name badge or place a blank nametag over the company logo. We appreciate your cooperation in regards to this matter!

"How to Work with Investment Property SELLERS"

By Tom Lundstedt, CCIM
www.tomlundstedt.com
www.howtoinvestinrealestate.org
800/508-4433

Investment Property Worksheet

This form is designed to assist in estimating the first year benefits of a real estate investment. It does not consider the effect of selling or exchanging the property in the future. This form is not a substitute for legal or tax advice. Anyone contemplating the purchase of a real estate investment should seek the services of competent legal and tax advisors.

Purchase cost $ 390000
Cash invested $ 84000
Financing: Amount 306000 Rate 7% P&I 2036 per month
Financing: Amount ______ Rate ______ P&I ______ per month

				Depreciation
Land value	$ 58500			
Personal property value	$ 39000	x 20 %	=	$ 7800
Building value	$ 253500	x 3.48	=	$ 8822
Land improvement value	$ 39000	x 5 %	=	$ 1950
Total depreciation				$ 18572

Annual rent 59700 Less vacancy 5% = Gross operating income 56715

Annual operating expenses

Real estate tax	______	Insurance	______
Repairs	______	Utilities	______
Association dues	______	Advertising	______
Management	______	Supplies	______
Miscellaneous	______	Miscellaneous	______

Total operating expenses $ 26650

I. Gross operating income			$ 56715	
Minus:	operating expenses	-	$ 26650	
Equals:	net operating income	=	$ 30065	
Minus:	annual debt service (monthly P&I x 12)	-	$ 24432	
Equals:	cash flow before tax	=		$ 5633
II. Annual debt service			$ 24432	
Minus:	interest	-	$ 21321	
Equals:	principal reduction	=		$ 3111
III. Net operating income			$ 30065	
Minus:	interest	-	$ 21321	
Minus:	total depreciation	-	$ 18572	
Equals:	taxable income	=	$ <9828>	
	Multiplied by tax bracket	x	35 %	
Equals:	tax paid or saved	=		$ 3440 saved
IV. Appreciation (estimate)				$

Return on investment with appreciation
Cash flow before tax + Principal reduction + Tax saved + Appreciation / Cash invested = ______%

Return on investment without appreciation
Cash flow before tax + Principal reduction + Tax saved / Cash invested — 12184 / 84000 = 14.5 %

Capitalization rate
Net operating income / Purchase cost — 30065 / 390000 = 7.7 %

Cash on cash
Cash flow before tax / Cash invested — 5633 / 84000 = 6.7 %

This material is designed to provide information about the subject matter covered. The accuracy of the information is not guaranteed. This material is sold or offered with the understanding that the author and/or publisher are not engaged in rendering legal, accounting or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Investment Property Worksheet

This form is designed to assist in estimating the first year benefits of a real estate investment. It does not consider the effect of selling or exchanging the property in the future. This form is not a substitute for legal or tax advice. Anyone contemplating the purchase of a real estate investment should seek the services of competent legal and tax advisors.

Purchase cost $ ______
~~Cash invested~~ NET EQUITY $ 50000
Financing: Amount 42000 Rate 9 P&I 441 per month
Financing: Amount ______ Rate ______ P&I ______ per month

				Depreciation
Land value	$	x ___ %	=	$
Personal property value	$	x ___ %	=	$
Building value	$	x ___ %	=	$
Land improvement value	$			$
Total depreciation				

Annual rent 14400 Less vacancy 864 = Gross operating income 13536

Annual operating expenses

Real estate tax		Insurance	
Repairs		Utilities	
Association dues		Advertising	
Management		Supplies	
Miscellaneous		Miscellaneous	

Total operating expenses $ 4900

I.	Gross operating income		$ 13536	
	Minus: operating expenses	-	$ 4900	
	Equals: net operating income	=	$ 8636	
	Minus: annual debt service (monthly P&I x 12)	-	$ 5292	
	Equals: cash flow before tax	=		$ 3344
II.	Annual debt service		$	
	Minus: interest	-	$ 3716	
	Equals: principal reduction	=		$
III.	Net operating income		$ 8636	
	Minus: interest	-	$	
	Minus: total depreciation	-	$ 2100	
	Equals: taxable income	=	$	
	Multiplied by tax bracket	x	%	
	Equals: tax paid or saved	=		$
IV.	Appreciation (estimate)			$

Return on investment with appreciation = ______ %
Cash flow before tax + Principal reduction + Tax saved + Appreciation
Cash invested

Return on investment without appreciation = ______ %
Cash flow before tax + Principal reduction + Tax saved
Cash invested

Capitalization rate = ______ %
Net operating income
Purchase cost

Cash on cash = ______ %
Cash flow before tax
Cash invested

This material is designed to provide information about the subject matter covered. The accuracy of the information is not guaranteed. This material is sold or offered with the understanding that the author and/or publisher are not engaged in rendering legal, accounting or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Case Study #1

You have a client who has owned a rental duplex for the past 16 years and believes it's a great investment. He plans to retire in another 15 years, or so, and use the duplex to provide a large part of his retirement income. You offer to do a "Return on Equity Analysis" for him. He's not quite sure what you're talking about but figures, what the heck, it's free! Here's what you learn:

Current value:	$100,000
Current loans:	42,000 @ 9% @ 441/month
Current annual rent:	14,400/year
Vacancy:	About 6%
Operating expenses:	4900.00 (from schedule E)
This year's interest payments total:	3716.00
Total depreciation for this year:	2100.00 (from schedule E)
Transaction costs (if he were to sell)	8%
Tax bracket:	35%

a. Please calculate your client's "net equity." (It's the amount he'd walk away from the closing with, if he sold.)

b. Use the Investment Property Worksheet to calculate his return on equity.

Case study #2

You are in the process of purchasing a small apartment building which has a cost of $500,000. Your accountant has advised you to use the assessor's land/building ratio of 20% for land and 80% for building.

Calculate your depreciation for the first two years (assume a January purchase).

Before the closing you attend a seminar taught by some guy who talked about bifurcating. He really got your attention when he showed you how to depreciate personal property and land improvements.

Re-calculate the depreciation on your small apartment building by assuming the personal property value and land improvements are each 10% of your $500,000 purchase cost. How much extra depreciation does this method provide? How much extra tax do you save (35% state and federal bracket)? How long will it take you to get a new accountant?

I. Calculating Your Taxable Gain

A. Adjusted basis = ____________________

+____________________

-____________________

= Adjusted basis

B. Gain = ____________________

-____________________

-____________________

= Gain

When selling an investment property it's very important for the Seller to ____________________. The best place to ____________________ is on the ____________________.

II. Capital gain tax rates:

For sales of long-term capital assets held longer than ____ months the maximum capital gains tax-rate (federal) is now ________. However, any portion of the gain resulting from depreciation deductions on real property is taxed at a maximum rate of _________. Any portion of the gain resulting from depreciation deductions on personal property is taxed as ordinary income and could rise to a maximum rate of ________. Keep in mind these rates are for the federal tax only. The state tax would be in addition to these amounts!

Case Study #3

Several years ago you purchased a small strip shopping center for $200,000.

After many years of ownership you sell the property for $325,000. Your cost of sale is 8%, your mortgage balance is $120,000 and you took a total of $49,000 in depreciation over the years. Please calculate your adjusted basis, gain and tax. (assume you're in a 30% tax bracket (combined State and Federal).

III. How to value a rental property or business

A. Gross multiplier
    1. Formula:

    2. Limitation: Does not take into account ________________

B. Capitalization rate
    1. Formula:

    2. Limitation: Does not take into account ________________

C. Cash on cash
    1. Formula:

"Float and Desire" Formula

The five ingredients are:

Loan factor	=	________
LTV	=	________
Down payment	=	________
Cash on cash	=	________
NOI	=	________

Four step "recipe":

1. Lender's return	=	________ (LTV)	x	________ (Loan factor)	=	________
2. Buyer's return	=	________ (Down payment)	x	________ (Cash on cash)	=	________
3. Add 'em up	=	________ (Lender's return)	+	________ (Buyer's return)	=	________ Cap rate
4. Value	=	________ (NOI)	÷	________ (Cap rate)	=	________ Investment value

Double check:

	________	Investment value
minus	________	Down payment
equals	________	Loan amount
	________	Down payment
times	________	Cash on cash
equals	________	Cash flow before tax
	________	NOI
minus	________	Cash flow before tax
equals	________	Debt service
divided by	________	Loan factor
equals	________	Loan amount (loan amounts should be equal)

This material is designed to provide information about the subject matter covered. The accuracy of the information is not guaranteed. This material is sold or offered with the understanding that the author and/or publisher are not engaged in rendering legal, accounting or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

"Float and Desire" Formula

The five ingredients are:

Loan factor = ______________

LTV = ______________

Down payment = ______________

Cash on cash = ______________

NOI = ______________

Four step "recipe":

1. Lender's return = ______________ (LTV) x ______________ (Loan factor) = ______________
2. Buyer's return = ______________ (Down payment) x ______________ (Cash on cash) = ______________
3. Add 'em up = ______________ (Lender's return) + ______________ (Buyer's return) = ______________ Cap rate
4. Value = ______________ (NOI) ÷ ______________ (Cap rate) = ______________ Investment value

Double check:

______________ Investment value

minus ______________ Down payment

equals ______________ Loan amount

______________ Down payment

times ______________ Cash on cash

equals ______________ Cash flow before tax

______________ NOI

minus ______________ Cash flow before tax

equals ______________ Debt service

divided by ______________ Loan factor

equals ______________ Loan amount (loan amounts should be equal)

This material is designed to provide information about the subject matter covered. The accuracy of the information is not guaranteed. This material is sold or offered with the understanding that the author and/or publisher are not engaged in rendering legal, accounting or other professional services. If legal advice or other experi assistance is required, the services of a competent professional should be sought.

Case Study #4

Your best client is a developer who is planning to build a shopping center if you can find an appropriate site. You and the developer have projected that the shopping center will produce net operating income of $550,000 once the project is complete. You also calculate that the entire cost of the project (excluding land) will be $3,500,000.

The banker says the available financing is for a term of 20 years at a fixed interest rate of 9.5% with 30% down payment.

If the developer demands 12% cash on cash how much can he afford to pay for the land?

Case Study #5

You receive a phone call from an investor who is interested in one of your listings. The investor says she will purchase the property if she can receive a 10% cash on cash return. Given the following information, what price will meet the investor's goal:

Property type:	Strip shopping center
Net operating income:	50,000
Available financing:	25% down, 10% interest, 15 year amortization

Case Study #6

You are considering the purchase of a rental house that generates a net operating income of $7,000. Your banker says the available financing will require 20% down payment, 9% interest and will be amortized over 20 years. If you desire 10% cash on cash what price would you pay?

- What if the market was such that buyers were happy to merely break even (zero CFBT)?

- What if the market was so strong the buyers were willing to buy with negative CFBT of $2000?

- What if the loan was adjustable and the rate rose to 10%?