the Property report

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Determining Effective Gross Rental Income

(Second in a Series)

- by Carter Froelich, CPA

The basic premise behind preparing a cash flow analysis related to a real estate investment is that you want to purchase a property such that the cash flow generated from the real estate investment is positive from the first month. More specifically, you want the rents collected from the property to not only pay for the monthly operating expenses of the property, but also the debt service on funds which may have been borrowed to purchase the property. In my mind, if an individual is purchasing properties which do not generate a positive cash flow from the date of acquisition, that individual is not an investor in real estate but is rather a speculator in real estate. Our articles are going to focus on real estate investing and not real estate speculating.

The Property Ledger™ was developed to provide real estate investors with an accessible financial tool which would not only crunch the numbers related to the cash flow of a single real estate asset but also that of your entire real estate portfolio. However, when teaching course on how to utilize The Property Ledger™ it became apparent that many investors were not fully up to speed on the financial terms which are utilized in the preparation of a cash flow analysis. To address this issue I will be presenting a series of articles which deal with the terms, concepts and fundamentals of cash flow analysis. This article will deal with key financial terms utilized in cash flow analysis revolving around the determination of rental income.

Rental Income – This is also known as "Scheduled Rents" or "Gross Scheduled Rents" and represents the total rental revenue which the property would achieve upon the collection of the rents of the occupied units as well as the potential market rents from all of the vacant units for a 12 month period using the current market rental rates for your particular property. Market rents are derived from your investigation of the market in which your property is located. Additionally, if the property in question is currently not achieving market rents you would need to determine the costs necessary to bring the property up to current market rental rates and included this cost in your cash flow analysis. Using The Property Ledger™ this is done in the "Future Improvements" section of the cash flow analysis. As a general rule of thumb, a single family home should generate a monthly rental rate of between 1.00% and 1.33% of the purchase price to support a 100% financed transaction. For example, if you purchase a home for $100,000, you should ideally rent the home from between $1,000 to $1,300 to have a positive cash flow. Remember that all market rents are determined by the market so it is important to have working knowledge of the market in your area. In performing your market analysis you may want to utilize our Real Estate Navigation Forms™ which may be downloaded at our website (www.thepropertyledger.com).

Other Income – Other income comes from sources other than rental of the units. Such income may include coin-operated equipment such as washers and dryers, soft drink and candy machines, and electronic games. This category also includes rents from storage lockers, boat docks, and parking for which tenants pay as well as late fees.

Gross Rental Income – Represents the total of Rental Income plus Other Income.

Vacancy / Credit Allowance - As we all know it is unlikely that all of our units will be occupied 100% of the time. As such, it is important to factor into the cash flow analysis the downtime which an investment property is estimated to experience during the year to account for the fact that tenants move out of units and that it takes time to ready the unit for leasing and to lease the unit to a new tenant. This is especially important in that we have already assumed in our Rental Income estimate that 100% of our units are leased at the beginning of the year. Here again, it is important for you to have a good understanding of the submarket in which your property is

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Feature Article

located. In a well located enchanted area in which there is a huge demand for rental property, you may want to utilize a 4% to 6% vacancy allowance. This would allow for a 15 to 20 vacant days per year per unit. If you are in a less desirable area in which there are multiple competing properties for lease you may need to use a 15% to 20% vacancy rate which would equate to 55 to 73 days vacant. The time it takes to lease a property will have a significant impact on the cash flow of your investment property. This is why it is important to purchase investment grade property in enchanted areas. For more information on this topic you may want to review the Lynch Pins of Real Estate Investing available at www.thepropertyledger.com/buy. The other factor to include in your Vacancy Allowance estimate is an allowance for uncollectable rents. This is why sometimes this category is also referred to as "Vacancy and Collection Allowance". This may be not be a factor if you are purchasing property in great locations with high demand from credit tenants, however, if your property is located in less desirable area with less qualified tenants, this figure could add another 2% to 3% to your Vacancy Allowance.

Effective Gross Rental Income may be illustrated by the following formula:

Effective Gross Rental Income

Gross Scheduled Rents
+ Other Income
= Gross Rental income
– Vacancy/Collection Allowance
= Effective Gross Rental Income

Effective Gross Rental Income represents Gross Rental Income less the Vacancy/Credit Allowance and represents your best estimate of the available funds which will be collected during the year and available to pay operating expenses and debt service. The subject of operating expenses will be discussed in our next issue.

- Property Strategies™
"Linch Pins of Real Estate Investing"

Property Strategies™

A PUBLICATION OF THE PROPERTY LEDGER Linchpins of Real Estate Module

The Linchpins of Real Estate Investing™

If you are going to be a real estate investor who is looking to purchase investment property for the
long term and create the financial tools and options which will create a myriad of options for you to
enhance property values and harvest cash flow over the years; then you need to understand

The Linchpins of Real Estate Investing™

- Location
- Enhanceablity
- Terms

Location – Enchanted Areas

To do well over the long term in the arena of real estate investing whether this means flipping
ties or buying for a long term hold, then purchasing properties in great locations is a must.
have heard that the secret to making money in real estate is "location, location, location".
the key to the Real Estate Wealth Building System™. Well located property is typically foun
7 to 10 mile radius of a major metropolitan employment center in areas of the community
"enchanted". "Enchanted" is defined as areas which are highly sought after because wi
walking distance they offer coffee shops, restaurants, parks, playgrounds, quality scho
wooded lanes, public transportation, entertainment venues, and employment opportun
you a better idea of what is meant by "enchanted", I own a number of investment propert
of 40th Street and Camelback Road in Phoenix, Arizona. Within this neighborhood the
the best public schools in the state, public parks, walking/jogging paths along a ca
which was converted into a wine bar, ten highly noted restaurants, a gourmet specia
pizza restaurant which has been written-up in the New York Times as having some of
the United States. As a result of this area's charm and amenities, it is highly sought af
buyers alike.

The reason you want to find enchanted neighborhoods is because people will al
these areas whether they want to purchase a home or rent. Homes built on the
not be where people want to be long term. Sure these houses are nice and they
ever, they do not provide the sense of community and interaction which the
hoods provide. Second of all, the areas on the outskirts of town are not prov
areas have proven themselves over the years. As such, it is recommende
enchanted areas and focus your real estate investment activities in these are
to be a real estate investor rather than a real estate speculator.

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Forget the Banks

– Carter Froelich

Given the difficult lending standards that the banks are requiring real estate investors to adhere to, it is almost impossible to qualify for a traditional mortgage if you own more than 10 investment properties. Accordingly, it is time to "forget the banks" and find other sources of financing. By other sources of financing, I am not referring to your standard "hard money" lender where you can borrow up to $500,000 at 15% for one year with 5 points; I mean patient money with flexible terms such as 5% to 6% interest only or more payments with a 7 to 15 year term.

One can locate this type of investment financing in two ways: (i) involving the seller in the financing of the purchase and, (ii) calling everyone you know with cash currently being held in a money market account earning interest at 25 basis points (i.e. one quarter of 1%) and asking them if they would like to increase their interest earnings by 20 times.

Involving Sellers

The best way to find sellers willing to provide seller financing is to narrow your search of properties in your selected market area to properties which have not sold over the last 15 years. By searching for properties I mean using your Wealth Team™ Title Agent to run a search for all properties in your area that meet this criteria and sending letters to the owner inquiring as to whether they are willing to sell their property. By seeking out properties which have not changed hands in over 15+ years you're going to find properties which have significant equity, which means that the seller may be willing to sell the property and take back a purchase money mortgage for some portion of the purchase price.

For example, say you find a seller who has owned their home for 30 years and owns their home free and clear. The purchase price you negotiated is $200,000 and during the course of your discussions with the seller you learned that the seller is going to put the net sales proceeds in the bank. You know that given the current economic climate that the bank will only be paying 15 basis points per year in interest on money which it holds. In this instance the seller will be generating $276 per year on their net sales

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proceeds of $184,000 ($184,000 x .0015). As such, you approach the seller with the following offer; $50,000 down and the seller to carry back a $150,000 promissory note secured by a first deed of trust on the property payable in 6% interest only or more payments with a balloon payment in 10 years. With this offer the seller is able to pay their closing costs, put some cash in their pocket and now receive monthly payments of $750 or $9,000 annually. Meanwhile you have found flexible financing without having to go to the banks.

Frustrated Holders of Cash

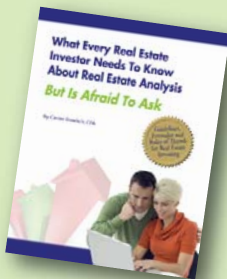
With many families and individuals having diligently saved their money for years, they now find themselves actually losing money by keeping their funds in the bank. Banks are currently paying 15 to 20 basis points per year in interest and as inflation is currently at 3.8% per annum, this 360 basis point difference is eroding their purchasing power. Given the uncertainty of economy many investors are not interested in gambling with the stock market and are looking for ways to increase their interest yields. This is where you can offer them rates of 5% to 6% secured by income producing property where there is plenty of equity and the net rents from the property service the debt. Let's run the numbers to see what the benefit would be for an investor who has $500,000 in a Schwab money market fund earning 25 basis points. Given the aforementioned Schwab money market rate this individual would generate $1,250 ($500,000 x .0025) in annual interest earnings. Alternatively, if they provided you with the $500,000 and you were able to invest the proceeds in well located, enchanted real estate whereby there was plenty of equity and cash flow to pay the lender 6% interest only or more payments; the lender would be receiving $30,000 ($500,000 x 6%) annually. This represents a 2,300 percent increase in their interest earnings! I do not believe that this would be a difficult conversation provided you are a knowledgeable, competent real estate investor with a well located stable investment property.

At present there are billions and billions of dollars that are being held in underperforming investment instruments that could be put to work assisting individuals improve their quality of life. The banks are obviously unwilling to assist the real estate investment community to finance real estate acquisitions and I believe that now is the time that we "forget the banks" and seek out other lenders to create a win-win environment for both the lender and the real estate entrepreneur.

The Property Ledger™ News

New Property Ledger Publication

The Property Ledger™ is pleased to announce the addition of their latest publication ***What Every Real Estate Investor Needs to Know About Real Estate Analysis But Is Afraid to Ask*** which describes guidelines, formulas and rules of thumb related to performing financial analysis related to the acquisition of real estate investments. Get your copy today for only $9.95 at - *www.theproepertyledger.com/buy*



Personal Real Estate Investor Magazine

Carter Froelich is writing articles for the *Personal Real Estate Investor Magazine* related to performing financial analysis related to the acquisition and financing of real estate investments.

See the *Personal Real Estate Investor Magazine* website at *www.personalrealestateinvestormag.com*

American Rental Property Owner's and Landlord Association

Carter Froelich was asked to provide articles and videos related to real estate financial analysis to the American Rental Property Owner's and Landlord Association ("ARPOLA"). Look for the first videos in the fall of 2011. ARPOLA is a fantastic organization for property owners which provides free state specific leases and legal notices, discounts at Lowe's, reduced pricing on property insurance among other beneficial services all for a nominal fee of $35 per year. See the ARPOLA website at *www.arpola.org.*

Follow Us On Facebook – In order to receive meaningful articles and news related to real estate investing follow us on Facebook under ***The Property Ledger.***

The Tax Corner

Enhance your real estate deduction by cost segregation - Under federal tax laws and generally accepted accounting principles, cost segregation is the process of identifying personal property assets that are grouped with real property assets and include such items such as air conditioners, appliances, heating units, fences, etc. and breaking out these personal property assets for tax reporting purposes. A cost segregation study identifies and reclassifies a property's personal property assets to shorten the depreciation time frame for taxation purposes thus increasing operating expenses and reducing current income and your tax obligations. For more information on this subject consult your CPA Wealth Team™ member.

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