the Property report

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The Importance of Financial Literacy and Cash Flow Analysis *(First in a Series)*

- by Carter Froelich, CPA

Introduction

It is my intention to provide information which will be not only informative but also will be able to be utilized immediately by the reader in their day-to-day real estate investment activities. Over the course of the next issues I will be providing articles relate to: (i) preparing real estate cash flow analysis; (ii) explaining various financial return metrics and why they are important; (iii) providing tips on how to secure financing when traditional lending sources are not lending; (iv) estimating market value; (iv) how to become a bank to assist others in purchasing property in addition to other relevant real estate investing topics. With that serving as a brief introduction let's discuss why it is so important to be financial literate and have a basic understanding of cash flow analysis.

Financial Literacy and Cash Flow Analysis

You can make a lot of money by investing in real estate. You can also lose a lot of money investing in real estate. There is a right way to invest in real estate and there is a wrong way to invest in real estate. It is my intention to provide you with information related to the right way to invest in real estate.

Investing in real estate is a numbers game and I do mean that you have to know to the numbers. If you are not interested in learning the numbers, and there a lot of them, you may as well stop reading and find another investment vehicle to get to where you want to go (if you can find one as powerful as real estate investing).

Numbers are at the heart at of real estate investing and connect to the four critical elements that surround income property investments which I refer to as the four basic returns of real estate investing which include:

1. Cash Flow
2. Appreciation
3. Loan Amortization
4. Tax Benefits /Tax Shelter

If you are to be successful in real estate you have know numbers in relation to the area in which you are investing. These numbers include: sale prices, rental comparables, days on market, capitalization rates, vacancy rates, rental concessions, average expenses per square foot, expense ratios, property tax rates, insurance rates, loan terms, loan origination costs, interest rates, amortization tables, depreciation rules, recapture provisions, ordinary income tax rates, capital gains tax rates, as well as passive loss rules just to name a few.

I have been involved in the analysis of real estate investments for over 25 years, I am a certified public accountant and a former state certified general real estate appraiser, I have managed an office of a national real estate consulting firm for the last 17 years and have developed The Property Ledger™ which is designed to assist real estate investors evaluate prospective real estate deals. During this time I have run across investors many who have had no working knowledge of the "numbers" and how to evaluate a potential real estate transaction. While some of these individuals have managed to hold on to some portion of their net worth; the great majority have not and would be great case studies as to what not to do in relation to real estate investing.

It is my goal and solemn wish to make sure that you are not one of these case studies but rather a successful real estate investor who is knowledgeable of their local market and of cash flow analysis. When you know how to crunch the numbers you chances of success are greatly improved and you will have the ability to be reasonably certain of the outcome of your real estate investments and the resulting investment returns. Try and say this about the stock market (i.e. GM, Enron, and Lehman Brothers). Once you begin the learning process and begin to run the numbers you will see how easy this process may be. While the process may be easy it will take a commitment on your part to learn the aspects of your particular market, understand the basics related to the tax implications of real estate investing and yes crunch the numbers.

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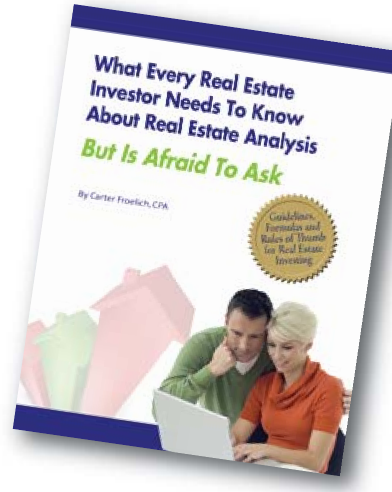
Feature Article

Crunching the numbers can take many forms from something as basic as a piece of paper and a pencil, a financial spreadsheet application or a sophisticated financial software program like The Property Ledger™. Whatever tool you decide to use, you have to make the decision to "decide" that whatever it takes, you will stay the course to become financial literate as it relates to real estate cash flow analysis.

In the Fall Issue we will begin with the topic of Determining Gross Rental Income. In the interim, if you want to learn more on the topic of financial analysis, pick a copy of ***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 on our website at ***www.theproepertyledger.com/buy***.



The Tax Corner

Real Estate Professional Tax Status

If you are reading this newsletter I am assuming that you are a real estate investor and as such you MUST read and understand this. The reason is because this is by far the biggest mistake that I see made by real estate investors and this is a mistake that will cost you thousands of dollars.

What I am referring to is the real estate professional status. I recently meet an individual who had been working with a CPA for many years and was always told she has been benefiting from the tax deductions as a real estate professional. However, when her CPA quit practicing and she moved to a new accounting firm, she was told by her CPA that she did not qualify for professional status and that her previous CPA had prepared her taxes wrong and she lost out on $20,000 of a tax refund.

So what exactly is the real estate professional status? Well, it actually has nothing to do with your education, professional licenses that you hold, or what type of business you are in. Rather, the IRS looks to what you do for real estate and how much time you spend in your real estate activities. The reason that you want to qualify for the real estate professional status is because without the real estate professional status, your ability to actually benefit from your real estate tax deductions may be limited.

As a real estate professional, however, you get to take advantage of an unlimited amount of real estate deductions each year on your tax return.

Contrary to popular belief, the real estate professional status is not taken by simply indicating that as your occupation on your tax return. It is not a specific form to fill out or even a particular box to check. Rather, it is an election that must be attached to your tax return at the time you file it.

The IRS rules for claiming Real Estate Professional Status are very clear, and require that two key criteria be met in the given tax year:

1. More than half of the professional hours worked throughout the year must have been devoted to material participation in real estate activities;
2. More than 750 hours of material participation in real estate activities in the tax year being considered.

If you think you can satisfy both of those criteria in a given year, I highly recommend working with your CPA or accounting professional to ensure that you properly document your time and efforts to allow you to claim Real Estate Professional status, and in return, keep more of your hard-earned profits.

If you invest in real estate, make sure you speak to your tax preparer to ensure that election is in place before you send off that tax return. *The average tax savings between a real estate professional and someone who is not a real estate professional is anywhere between $15,000 to $35,000 each and every year!*

Hunting For Terms

– Carter Froelich

In case you haven't noticed, once you own a certain number of properties usually 6 to 10; it is almost impossible in this credit environment to get a mortgage from a commercial bank for the acquisition of investment grade real estate. In order to get around this challenge, I have gone back to acquiring properties the way I did when I first started investing and this is by employing seller financing in my acquisition.

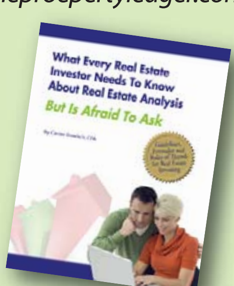
As real estate prices have fallen dramatically in the markets in which I invest (i.e. Phoenix, AZ) there are not many properties which are on the market today which offer this type of financing. As such, I am being proactive to find such opportunities by sending out inquiry letters to individuals in the market in areas in which I am hunting for enchanted properties (see the Lynch Pins of Real Estate Investing – *www.thepropertyledger.com/buy*) asking if they are interested in selling their property.

When sending out the inquiry letters, I am searching for properties in the lower ½ of the range of assessed valuation for that particular area that have not had a change in their deed of trust (other than a quit claim deed) for over 12 years. This way I know that I am mailing inquiry letters to individuals how have equity in their properties. Should they be interested in selling their property, I eventually move to the topic of what they plan on doing with the money from the sale. The typical response which I get is that they are going to pay-off some bills and "put the rest in the bank". I inform them that banks are currently willing to pay 0.2% to 1.4% for their money and wouldn't they rather earn 6% with me. **As this generally represents a 2,900% to 328% increase in the rate of interest that they will be making it is not a difficult negotiation.**

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 was recently selected to provide six articles per year to the Personal Real Estate Investor Magazine related to performing financial analysis related to the acquisition and financing of real estate investments. Look for the first article in the next issue of the magazine. 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*.

The Property Ledger™ Tip

Adding a Rent Roll

The Property Ledger ™ allows you to prepare customized rent rolls for 2 to 1,000 units with individual unit descriptions as well as monthly rental rates. Rent rolls are typically used for multi-unit properties as opposed to single family homes. In order to prepare your rent roll perform the following steps:

1) Click on the property for which you want to enter a rent roll.
2) Click on "Rental Income"
3) Click on "Enter Rent Roll"
4) Click on "Add Many Rent Rolls"
5) Input the number of units for which you want to create rental information (i.e. the number of units in your property)
6) Click on "Submit"
7) Input the unit description (i.e. Unit Number)
8) Input the monthly rent for each unit.
9) Complete inputting information of all units.
10) Hit "Submit".

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