Sales Associate Course

Chapter Seventeen

Real Estate Investments and Business Opportunity Brokerage
Investment Analysis

- Most important consideration:
  - Economic soundness

- Land use controls
  - Zoning
  - Deed restrictions
  - Permitting requirements

- Economic force
  - Population growth
  - Foreign capital
  - Impact of taxation
Investment Analysis

Advantages

- Income
- Equity build up
- Appreciation in value
- Tax benefits
- Positive leverage
- Prestige
Investment Analysis

- Disadvantages
  - Illiquidity
  - Immobility
  - Expense/overhead
  - Additional expertise from
    - Real estate brokers
    - Tax accountants
    - Attorney’s etc.
Types of Investment Properties

- Agricultural
- Business Opportunities
- Commercial
- Industrial
- Office
- Residential
  - Condominiums
  - Villas
  - Single family homes
  - Apartment complexes
Real Estate Investment Trust (REIT)

- Individuals pooling their resources for investment
- Professionally managed portfolio
  - Real property
    - Office buildings, apartment complexes, retail centers
  - Mortgages secured by real property
- Similar to mutual fund
Static vs. Dynamic Risks

- **Dynamic risk**
  - Associated with general market conditions
  - Can not be shifted to an insurer

- **Static risk**
  - Can be transferred to an insurer
  - E.g. fire, theft or vandalism
Dynamic Risks

- Dynamic risk comes in many forms
  - Business
  - Financial
  - Inflationary
  - Interest rate
  - Liquidity
  - Market
Leverage

- Use of borrowed funds, or OPM - other people's money; (AKA "trading on the equity")
  - Positive leverage
    - rate of return greater than interest rate (increased return by borrowing)
  - Negative leverage –
    - rate of return less than interest rate
## Reconstructed Operating Statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential Gross Income</td>
<td>PGI (or GI)</td>
</tr>
<tr>
<td>Vacancy and Collection loss allowance</td>
<td>- V&amp;C (% or $)</td>
</tr>
<tr>
<td>Other Income</td>
<td>+ OI</td>
</tr>
<tr>
<td>Effective Gross Income</td>
<td>EGI</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>-OE</td>
</tr>
<tr>
<td>Net Operating</td>
<td>NOI</td>
</tr>
<tr>
<td>Annual Debt Service</td>
<td>-ADS</td>
</tr>
<tr>
<td>Before Tax Cash Flow</td>
<td>BTCF</td>
</tr>
<tr>
<td>Income Taxes</td>
<td>-TX</td>
</tr>
<tr>
<td>After Tax Cash Flow</td>
<td>ATCF</td>
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</tbody>
</table>

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Operating Expenses

- **Fixed Expenses**
  - Property Taxes
  - Hazard Insurance

- **Variable Expenses**
  - Maintenance
  - Utilities
  - Management fees

- **Reserve for Replacements**
  - Noncash expense
  - Use in the future to replace worn out components
Operating expense ratio

\[
\frac{\text{Operating Expenses}}{\text{Effective Gross Income}}
\]

Provides for comparison with similar properties
Loan to value ratio

\[
\frac{\text{Loan}}{\text{Value}}
\]

Shows the % of value the lender agrees to lend
Calculating Profit on Investment

\[
\frac{\text{Made}}{\text{Paid}} = \text{Profit or loss \%}
\]

- An investor paid $300,000 for a parcel of land and sold it for $200,000. What was the percentage of profit or loss?

\[
\frac{\text{Made}}{\text{Paid}} = \frac{($100,000)}{$300,000} = 33\% \text{ loss}
\]
Deductions from Gross Income

- Depreciation - allows investor to recover cost of improvements
  - Land (Site) does not depreciate
  - Deduction, but not expense
  - Not appraisal depreciation

- Straight-line method
  - Recovery Periods
    - Residential - 27.5 years
    - Non-residential - 39 years
Tax Depreciation Calculation

- EXAMPLE: A residential rental property sells for $225,000; closing costs were $17,000 and the land represents 20% of the value.
- What is the annual straight line depreciation allowance?

Solution

\[
\begin{align*}
\text{Total acquisition cost} & = \frac{225,000 + 17,000}{1} = 242,000 \\
\text{Basis for depreciation} & = 242,000 \times 0.8 = 193,600 \\
\text{Annual cost recovery} & = \frac{193,600}{27.5} = 7,040
\end{align*}
\]
Capital Gains Tax

- **Short term**
  - Property held for 12 months or less
  - Taxed at taxpayer's ordinary tax rate

- **Long term**
  - Property held for more than 12 months
  - 15% tax rate
  - 20% tax rate
    - Single > $400,000 annual income
    - Married, joint return > $450,000
Income Classification

Three categories of income

- **Active**: salary, tips and commissions
- **Passive**: income from activity in which investor does not actively participate, including any rental activity - even if investor actually participates
- **Portfolio**: dividends, interest, and capital gains
Tax shelter

- An investment that shields income from taxation
- Positive Cash Flow as property appreciates is ideal
- Tax shelter obtained by deducting interest and depreciation - especially depreciation - from net operating income
Capital Gains and Losses

- **Amount Realized**
  - **Capital gain**
    - Sold for more than paid
    - Taxed in the year earned
    - \( = \text{Sale Price} - \text{Expenses of Sale} \)
  - **Capital Loss**
    - Sold for less than paid
    - Loss may be carried forward to future years (passive income)
1031 Tax Deferred Exchange

- Like Kind Exchange
  - Investment real estate for investment real estate
  - Tax deferred

- Boot
  - Any unlike property received in exchange
  - Taxable now
  - e.g. cash
Installment sale

- **Gain**
  - Received over a number of years
  - Percentage received is taxable that year
  - Reduces tax due in any year
Business Brokerage

- Analyze financial statements
  - Reconstructed operating statements
  - Balance sheets
  - Income statements

- Business brokers
  - Sale, purchase or lease of a business
  - Must hold real estate license

- Business Enterprises
  - Transactions over $200,000

- Business Opportunities
  - Transactions under $200,000
Business Brokerage

- Sales frequently involve
  - Shares of stock
  - Limited partnership interests
  - Securities

- Be careful
  - May violate securities laws
  - Requires separate license
Appraisal Methods

- Comparable Sales Approach
- Cost-Depreciation Approach
- Income Approach
- Liquidation Value Approach
  - Value a failing business
  - Sell assets, pay liabilities
  - Minimum value of a profitable business
Appraisal Methods

- **Going Concern Value**
  - Value of an established, profitable business in excess of the value of the physical assets
  - Includes:
    - Real estate
    - Personal property
    - Licenses
    - Franchises,
    - Not compete contracts
Reasons for a Business Appraisal

- Sale / Purchase, etc.
- Obtain loan / insurance
- Condemnation
- Buy-sell agreements
- Property settlements
- Estate settlement
- Assign values for stock option plans
Accounting Terms

- **Assets**
  - tangible & intangible resources

- **Liabilities**
  - short-term & long-term obligations

- **Owners equity**
  - Assets minus liabilities

- **Capital**
  - owner's equity or net worth
Accounting Terms

- Tangible assets
  - Buildings, furniture, equipment, etc.
- Intangible assets
  - Stock shares
  - Trademarks
  - Copyrights
  - Research & development expenses
  - Franchises
  - Goodwill
Steps in the Sale of a Business

- Acquire the listing
- List the assets
- Valuation
- Deduct liabilities
- Valuation of stock
- Legal compliance
- Close the transaction
Auctioning Real Estate

- Licensed under DBPR
- Brokers do not need separate license
- By-bidders
  - Drive up the price with no intention of buying