**Rental Real Estate Report Explanation**

**Real World Personal Finance Software**

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Overview of the Rental Real Estate Reports

This text is to help you understand the overall concepts, and the technical details, of the following rental real estate analysis reports.

This rental real estate report estimates:

• All annual cash flows.

• Most of the usual rental real estate ratios.

• Pre- and post-capital gain tax IRR / NPV (internal rate of return and net present value).

IRR is the method of determining an overall average annual compound rate of return on a series of unequal cash flows. It's the only way to determine how well a complex investment such as real estate rentals really did over the life of the investment, because money flows in and out at random.

You can use the bottom-line IRR number to both estimate how an existing real-world rental property has done, and to do "What-if" scenarios on properties you're thinking about investing in - to see if the current price is worth it or not.

Net present value estimates what the property is worth today assuming your input, a discount rate, and all of the rental's annual cash flows, from when you first bought it, until after its sale.

IRR is just the way to calculate an investment's overall rate of return when there are multiple years with unequal cash flows. So any IRR number in years without the last cash flow (the pre-tax or after-tax sale of the property) is meaningless.

NPV is just the IRR calculation in reverse, so unless there's a sale input into a program, this is invalid too. So there has to be an estimated year of sale and amount input into the equation for any of these to display meaningful results.

The generic definition of NPV is: The present value of an investment's future net cash flows, minus the initial investment. If it's positive, then the investment should be made. If it is negative, then it should not be made, because you can do better elsewhere assuming you can get an average rate of return equal to, or better than, the discount interest rate you used to calculate NPV. This is why the discount interest rate input (into cell A10) should be a rate of return that you can get with confidence, over the same time horizon, by investing in something else safely – like a bank CD or other conservative investments.

This is confusing, so an example will help. In the single rental demo, the before-tax IRR is 8.97%. If you were to input 8.97% into the NPV input cell, you'll get a tiny number as a result. It should be zero, and would be if one were to input the rate using a few more decimal places. This means that if you did the math using all of the inputted cash flows of the property (which was done and is what the program is all about), the overall rate of return of the property since you bought it, until the end of the year in which it was sold, was 8.97%. That also means if you bought mutual funds that returns 8.97% all of the monies invested at the same time, you would have made just as much money in the end as you did with the rental, even after all of the great tax benefits of rental real estate.

Back to the example: If you input 9.5%, then you'll get around -$5,000 in cell F21. This means that if you would have had the exact same cash flows at the exact same time, and got 8.97% instead of 9.5% in mutual funds, you would have made $5,000 MORE money in mutual funds than the rental.

So if you are being "required" to get a 9.5% rate of return on your money, then you would have been disappointed by $5,000 by investing in this rental property. The bottom-line in this example, is that if your goal is to get 9.5% on your money with this property, then you should not have paid $250,000 for it (as inputted into cell A15 of the Input sheet). You should have only paid $245,000 for it.

Experienced real estate investors (and loan officers) can use NPV to value properties outright like this, and they can also use it to make apples-to-apples comparisons on similar properties. This is valuable and can end up either making lots of money, and/or can be used to avoid losing lots of money.

On the other hand, if you would have had only an 8% rate of return requirement on your money (instead of 9.5%), then you would have made your 8.97% back, and then, also around $10,000 on top of that (this is the difference between 8% and 8.97% over the investment horizon).

In this case the fair market value of the property (assuming all of your future input data happens, which we can guarantee that it definitely will not), would be around $270,000. In this case, the property is a great deal if you only expected to get 8% on it in the first place, or it only cost $250,000. In this case, you would have made $20,000 more than expected.

The reason NPV is one of the first input cells is to surprise you. Input the rate of return you think the property will achieve (and/or what you can realize using alternative investments, like mutual funds). The difference between that and the true return will be the surprise.

### Report Information Explained

*IRR before Capital Gains Taxes:* This is the overall annually compounded rate of return (given all cash flows) from purchase to sale. All of the annual cash flows of the property's life are summed, and then the IRR is calculated to give a meaningful bottom-line number. This is how much money it actually made – before paying after sale capital gains taxes.

*IRR after Capital Gains Taxes:* This is the overall annually compounded rate of return of the property after considering payment of the terminal capital gains taxes.

*Pre-tax Net Present Value:* Given all cash flows and taxation, this is the current estimated value of the property if you were to liquidate it today (for the market value input), before paying capital gains taxes.

*Post-tax Net Present Value:* Given all cash flows and taxation, this is the current real value of the property if you were to liquidate it today, after paying capital gains taxes. So if this NPV is much lower than a cash offer, then you should consider taking it.

*NPV Discount Rate Used:* This is the annual rate of return used to calculate the present value of all of the future cash flows. The larger the number input, the less the property's value will be. This is because this discount rate is what you could have received by investing in alternative vehicles (e.g., mutual funds).

*Annual Taxes Saved:* This is how much in taxes were saved from being able to deduct expenses from gross rental incomes.

*Gross Accounting Income:* This is how much income was realized annually from a taxation standpoint. This usually doesn't have much to do with how much actual cash flow you'll experience. This is shown in the last column – *Actual Realized Cash Flow*.

The last number in the *Actual Realized Cash Flow* column estimates how much annual cash flow the property returned after sale, and after paying capital gains taxes.

These are all estimates because nothing financial can be predicted with any accuracy.

### Projecting the Future

This report illustrates how values may change over time. Once you go over a year or so, most all financial projections will be substantially different compared to what was input into rental real estate software programs.

So it's important to run the numbers whenever something changes, or at least annually.

### Miscellaneous

Real growth must take inflation into account. If your average annual rate of growth is 7% and annual inflation is 3%, then your real rate of growth is only 4%.

Hopefully, all of the charts and graphs will be self-explanatory. If not, then feel free to contact us for more information.

A good measure of the benefit of financial planning and investment management is how your net worth improved over what you would have realized if you never met us, and continued doing what you were doing.