Superior School of Real Estate
Presents the
Secrets of Residential Investing
How to Build a Millionaire

Student Manual

North Carolina Real Estate Commission

Continuing Education
Student Information Sheet

READ IMMEDIATELY UPON CHECKING IN

Basic CE Requirement (21 NCAC 58A.1702)

The CE requirement to maintain a license on active status is **eight (8) classroom hours per year** (each license period) consisting of the four (4) hour Real Estate Update course (mandatory for all licensees) and a four (4) hour elective. The content of the Update course changes each year.

Important Points to Note

- Newly licensed licensees do NOT need to take any CE prior to their **first license renewal**, but must satisfy the CE requirement prior to their **second license renewal**.
- A course may not be taken for CE credit twice in the same license period. Make sure you have not already taken this course during the current license period.
- If your license is **inactive,** you should check with the Commission to ascertain the amount of CE you need to activate your license.

Attendance Requirement

In order to receive CE credit for a course, students must attend the entire scheduled class session. Sponsors and instructors may, on an individual basis, excuse a student for good reason for up to 10% of the scheduled class session (20 minutes for a 4 hours class session); however, a student must attend a minimum of 90% of the scheduled class session in order to receive a course completion certificate and CE credit. No exceptions to the 90% attendance requirement are permitted for any reason.

Student Participation Requirement

To help assure that the mandatory continuing education program will be one of high quality, the Commission requires that students comply with the following student participation standards:

> A student shall direct his active attention to the instruction being provided and refrain from engaging in activities unrelated to the instruction which are distracting to other students or the instructor, or which otherwise disrupt the orderly conduct of a class. **Examples of Prohibited Conduct**: Sleeping; reading a newspaper or book; performing office work; carrying on a conversation with another student; making or receiving a phone call on a cellular phone; receiving a page on a pager that makes a noise; loudly rattling or shifting papers; or repeatedly interrupting and/or challenging the instructor in a manner that disrupts the teaching of the course.

Sponsors and instructors are required to enforce the student participation standards. Sponsors have been directed to NOT issue a course completion certificate to a licensee who violates the standards and sponsors must report inappropriate behavior to the Commission.

Course Completion Reporting

Sponsors are responsible for reporting course completion information to the Commission via the Internet within **7 days of course completion.** Licensees are responsible for assuring that the real estate license number that they provide to the course sponsor is correct.

Licensees may address comments/complaints about courses, instructors, and/or sponsors to:

Continuing Education Officer
North Carolina Real Estate Commission
P.O. Box 17100
Raleigh, North Carolina 27619-7100

Certificates of Course Completion

Course sponsors will provide each licensee who satisfactorily completes an approved CE course a Certificate of Completion on a form prescribed by the Commission within 15 calendar days following a course. The certificate should be retained as the licensee's personal record of course completion. **It should not be submitted to the Commission unless the Commission specifically requests it.**

Check the Label of Your Newsletter

The number of continuing education credit hours credited by the Commission to your licensee record for the current license period as of a stated date will appear on the mailing label of each edition of the Commission's newsletter. You may also check your **current year's** CE credits online at the Commission's website: www.ncrec.state.nc.us. You will need to log in under Licensee Login using your license number and pin number. If you are unsure of your pin number, please follow the instructions on our website.

Please avoid calling the Commission office to verify the crediting of continuing education credit hours to your license record unless you believe that an error has been made. Please use our website to verify that your credit hours have been reported. Your cooperation in this regard will be especially needed during the May 15 - June30 period each year.

Len Elder, JD, DREI, Senior Instructor & Curriculum Developer

Len Elder is the Senior Instructor and Curriculum Developer for Superior School of Real Estate. With over 25,000 hours of live classroom presentations and teaching, Len has excelled to the top of his field and is recognized nationally as an author, speaker, course developer and a Distinguished Real Estate Instructor (DREI) by the national Real Estate Educators Association. Len joined Superior School in the fall of 2013.

With a B.A. degree in Speech Communications & Broadcasting and a law degree from Capital University, Len brings a multi-disciplinary approach into the classroom. His professional life spans the private practice of law, the mortgage banking industry, the real estate profession and the educational profession. He has served on numerous committees, acted as the President of the Southern Arizona Mortgage Brokers Association, served as a Board member of the national Real Estate Educators Association and is one of six elected people in the country who served on the Distinguished Real Estate Instructors Leadership Council.

For 10 years Len was the Senior Instructor at Hogan School of Real Estate in Southern Arizona and after that was the founder and CEO of the national education company, Course Creators. Len is a noted author **and** has written over 100 educational courses for real estate professionals throughout the United States, published law journal articles, been featured as the cover author of the REEA Magazine and created the national textbook for the training and development of instructors, ***Ovation – How To Present Like a Pro***. Len regularly delivers Instructor Development Workshops and has acted as the instructor for the real estate commissions and departments in North Carolina, Arizona, Utah, South Dakota, Iowa, Oregon, Idaho, Alabama, Oklahoma and others.

He is a regular presenter at national conventions and events. Most of all he believes that educational classes should be fun, exciting and he has dedicated his life to helping other people succeed.

Recipient of the John Getgey Award for Academic Excellence in the Practice of Law
Mortgage Broker of the Year, Tucson, Arizona
Marjorie Lewis Distinguished Service Award
Past Board Member of the National Real Estate Educators Association
Leadership Council of Distinguished Real Estate Instructors

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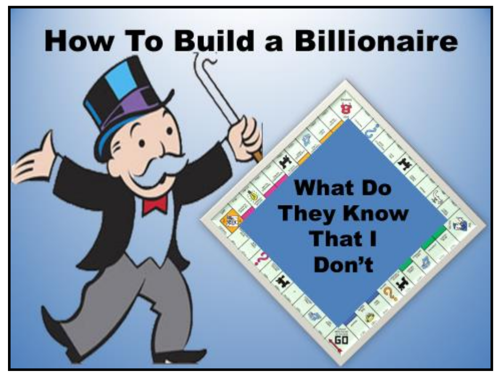
Section 1

Understanding Principles of Investment

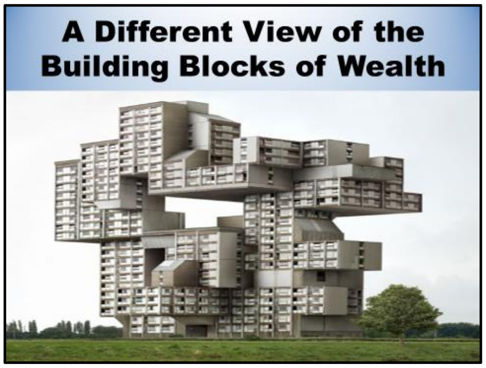
They are perfectly legitimate questions to ask.

1. **How is wealth really accumulated?**



2. **How did wealthy people get that way?**
3. **Who holds wealth and what does investing in real estate have to do with all of that?**
4. **Is investing in real estate really beneficial for my clients?**
5. **What do the wealthy know that I don't about residential real estate investment?**

Student Notes



A Harvard business professor asked 5,000 Americans how they thought wealth was distributed in the United States. He then compared their responses with the actual wealth distribution. The results are surprising and insightful and relate directly to the concepts of investing, saving and real estate acquisition.

Student Notes

Forbes annually publishes the sources of the wealth for the country's Top 400 wealthiest people. Rank the following from 1-10 with number one being the primary source of wealth today and 10 being the lowest source of wealth today:

- ☐ Media / Entertainment
- ☐ Technology
- ☐ Fashion & Retail
- ☐ Diversified
- ☐ Manufacturing
- ☐ Energy
- ☐ Finance
- ☐ Real Estate
- ☐ Food & Beverage
- ☐ Investment (Stocks & Options)

Student Notes

When a word cloud is created that indicates the sources of wealth, the words "Investment" and "Real estate" appear prominently. Many Americans believe that most of the wealthy people attained that status because of who they knew, what they inherited or the fact that they were wealthy when they grew up. The facts as reported by Forbes do not support this conclusion. The Business News Daily and Forbes have both reported that:

- The vast majority of millionaires are self-made
- 86% of them were not wealthy growing up
- Real estate is a key part of all their portfolios

The decision to invest in real estate is one that is well rooted in the history of real estate throughout the United States. Between 1926 and 1996, the annual average rate of return on real estate was 11.1%. There are numerous factors that make investing in real estate an appealing alternative to many individuals.

I think a good rate of return for a real estate investment would be:

____

Student Notes

The National Council of Real Estate Investment Fiduciaries (NCREIF) is an association of institutional real estate professionals who share a common interest in their industry. They are investment managers, plan sponsors, academicians, consultants, appraisers, CPA's and other service providers who have a significant involvement in institutional real estate investments. They come together to address vital industry issues and to promote research on residential investing. They have estimated the average current annual cash on cash return for residential real estate investment to be 10.15%.

Why Should Clients Choose Real Estate as an Investment?

Among the factors that drive investors are a potentially high rate of return, a shift from low return investments, a desire to remove risk and maximizing leverage.

Benefits of Residential Real Estate Investments

There are many benefits for the investor in residential real estate. Among those benefits, and those which we will be discussing throughout this course are all of the following:

- **Potentially High Rates of Return.** Real estate can carry a potentially high rate of return. Particularly when compared with other forms of investment, holding money in savings or purchasing CD's or bonds.

- **Shift from Low Return Investments.** Investors seeking rates of return have lots of options. Typically, when an investor purchases real estate they are moving money from a lower rate of return to a higher rate of return. They obtain the largest return on a long-term hold asset which is held with the intention of producing rental income. This appreciation is tax free, until sold, and opportunities to defer that income exist.

- **Desire to Minimize Risk.** Although no investment is ever risk free, investing in real estate provides collateral and security to back up the investment. Other investment opportunities contain the potential of losing everything. That is rare in real estate investments.

- **Ability to Quantify the Investment.** The ability to quantify and measure rates of return of the real estate asset is easier than with other types on investment and also gives the investor a measure of control that seldom exists with other investments.

- **Opportunity to Maximize Leverage.**

A Lesson In Leverage

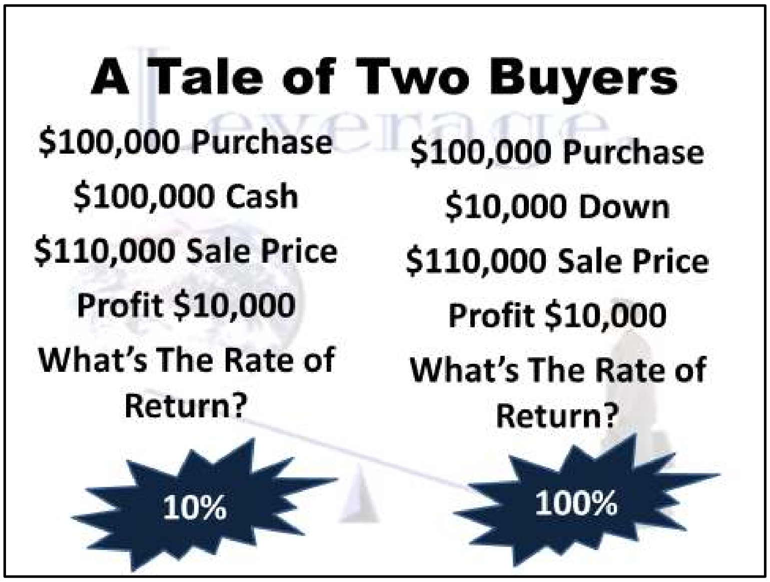
Most real estate investors understand the concept of leverage. Leverage is the ability to do more with less and is sometimes referred to as the principle which allows us to invest using "*Other People's Money*" (OPM).

In order to better understand the concept of leverage as it relates to real estate and rates of return, let's simplify a comparison between two buyers. The first buyer has $100,000 of cash and pays $100,000 cash for a property and sells it a year later for $110,000. (Yes, we realize that we have omitted transaction costs, but it will allow us to compare apples to apples in the example.) That investor realized a $10,000 return on their $100,000 investment and achieved a rate of return of 10%.

A second investor also has $100,000, but decides to put 10% down on the home, investing $10,000, and also sells it a year later for $110,000. For his investment of $10,000 the investor realized a $10,000 profit and achieved a rate of return of 100% on his money.

We could calculate all of the missing elements from the examples, but the contrast in rates of return is striking. The second investor of course had mortgage interest to pay, but he also took a tax deduction for that expense and still had his remaining $90,000 to invest in other ventures.

This is a good example of the concept of leverage at work.



Teaching Clients to Think Differently

A large part of our job as real estate licensees is to educate clients on the value and wisdom of investing in real estate. This means that as licensees we often have to encourage clients to think differently. Part of the reason that the video regarding *Wealth Inequality in America* is so poignant is because the top 1% does understand more about investing and particularly about investing in real estate than most Americans and our clients.

In order to appreciate the difference in mindset of what the top 1% knows that most of our clients don't know just ask yourself some basic questions (PPT Slides 31-33):

- When were you taught in math class about calculating investment rates of return?
- When were you taught about the benefits of residential real estate investing?
- When were you taught about interest rates and leverage principles?
- When were told any of the following:
    - How to create a family and investing budget
    - How to properly manage credit cards
    - How PayDay loans really work

What percentage of Americans do you think understand these things? We are willing to bet it's about 1%.

Student Notes

If we were not taught these things then neither were our clients. Working with potential residential real estate investors is an opportunity to educate them on all of the things they may have missed which have led to a great inequality of wealth.

Investors in residential real estate think differently. The average consumer doesn't understand the motivations that drive an investor and instead, due to recent housing downturns have talked themselves out of investing in residential real estate.

Far too often in the current real estate market we find investors and occupying homeowners using 2005 or 2006 as the benchmark year for their measurement of their real estate values. Typical comments include, "Do you realize how much I have lost on my home in the last couple of years?" or "Look at how much home values have been destroyed."

The knowledgeable real estate professional working with and guiding investors knows that the overall story is much different. 2005 and 2006 were aberrations in the value of real estate, no matter which charts, trends or statistics you want to use and the overall fact remains that over time real estate values have traditionally increased. It is only in the short term, speculative, over-leveraged aspect of real estate investing that risks were multiplied. As a long term investment real estate has always been a sound investment.

Each real estate investor comes to the table with their own objectives and agenda in mind. The reasons why investors are making an investment in real estate can vary greatly and often encompass a myriad of justifications. However, for the practicing licensee in North Carolina it is important to identify exactly which motivation may be the most important to any particular investor.

Student Notes

We can break the priority elements down into three essential categories that underlie the motivation of most investors. They are:

- **Cash Flow**
- **Equity/Appreciation**
- **Tax Advantages**

Though nearly all investors operate with a mixture of these priorities, there is usually one of the above priorities which acts as the overall driving force for any individual investor.

How would rank your priorities if you were investing in residential real estate?

_______ Cash flow

_______ Equity Appreciation

_______ Tax Advantages

Student Notes

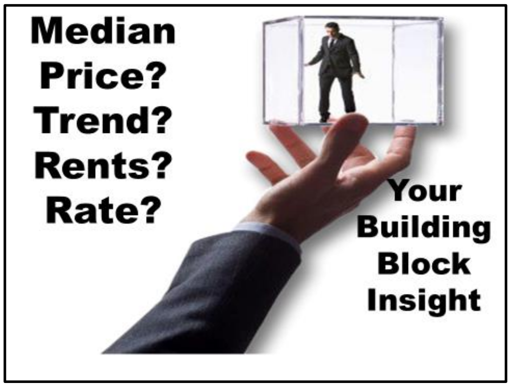
Student Notes

As with any market numbers vary greatly based on location and thanks to today's technology, the practicing real estate professional has many tools to analyze in depth current market conditions and trends. While local MLS systems provide guidance there are other tools that real estate professionals should be utilizing when working with investors in specific markets.

Some of the resources available to agents practicing in the Carolinas are:

- Market Trend Analyses Available on HouseHunt
    - **http://www.househunt.com/realestate-markettrends/NC/**
- North Carolina Real Estate Guides Available on Trulia
    - **http://www.trulia.com/city/NC/**
- North Carolina Home Values & Home Prices Available on Zillow
    - **http://www.zillow.com/local-info/NC-home-value/r_36/**

There is one more aspect of the current market of which real estate licensees should be aware. That is the fact that for a lot of investors, buying in the current market represents buying at a time when prices are low. Some of the same rules that apply to wise investing in the stock market apply to wise investing in real estate, particularly the old adage of buy low, sell high. Investors on the whole make more money in a buyer's market than they do in a seller's market. In other words they make money when the rest of the public is shying away from low priced homes, because investors know that these low purchase prices will equate into higher gains in the future. They have learned to buy when the prices are right and for an awful lot of investors, that time is now.



Local Numbers Which You Should Know

Student Notes

Student Notes

Section 2

Concepts of Residential Real Estate Investment

The Concept of Cash Flow

We have already determined that investors choose residential real estate investments on the basis of cash flow, equity appreciation and tax advantages. Now we can look at the more detailed concepts that investors need to consider in regard to each of these items.

Cash flow has a positive effect on the investor today. It can have positive ramifications such as when it creates passive income for the investor in the form of a positive cash flow on the property. While the income may be taxed it also minimizes the tax liability of the investor.

There are different types of cash flow. Any given property at a specific time can have a positive, negative or break-even cash flow. While the great majority of people may seek a positive cash flow, it is possible that an investor may consider a property with negative or break-even cash flow to be a good investment based on their individualized investment objectives.

A lot of investors have learned short cuts to analyzing a property over their years of investing. Julie Broad with Revnyou.com shares an extremely simple rule of thumb for analyzing cash flow. It is referred to by investors as the 1% rule. Basically, the rent that a property produces must equal 1% of the property's purchase price in order for the property to produce a positive cash flow.

Student Notes

When analyzing multi-family properties, the investor approach may be a bit different. Chuy Terrazas, a regular investor of multi-family class C & D properties utilizes a $100 per unit rule to initially determine the cash flow of a property.

Student Notes

Unfortunately, a lot of the general public and initial investors in residential real estate only look at cash flow as a method of measuring the rates of return on real estate investments. There are many rates of return that investors may realize when investing in real estate that go far beyond the positive cash flow that they may put in their pockets each month.

The Concept of Equity & Appreciation

Equity Appreciation is the amount of property equity that the investor gains over his/her period of ownership. Equity appreciation has an effect on the investor in the future since he/she will not realize the actualization of this gain until the time of sale or transfer.

The most immediate equity appreciation that an investor can gain would be at the time of purchase when the purchase price is below the market value of the property. The old adage of buy-low, sell-high applies here.

Increases in value gained during ownership are divided by appraisers into two different kinds of appreciation. Earned increments occur due to something physical done to the property by the investor, such as improvements or renovations. Unearned increments are caused by overall appreciation in the real estate market, not through improvements done to the specific property.

An investor who is utilizing rental payments to decrease a principle balance is also gaining increased equity appreciation.

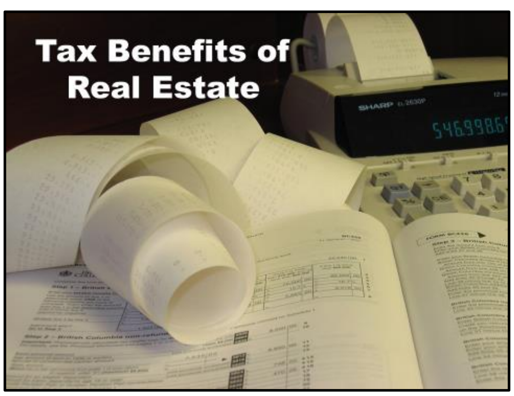
While it is impossible to predict the appreciation or increased future equity of any particular property, investors rely on market trends and historical averages in completing calculations. On average the annual appreciation of real estate has averaged 3.7%. This is true, despite what sometimes appear to the layperson as abnormal and unusual swings in the market.

To better understand any given market an investor and therefore, a real estate professional should understand market forecasts and data that pertain to their individual geographic areas of practice.

Some really good resources for this information are:

- The NC Economic Forecasts of Dr. John Connaughton of UNC
- Real Estate Stats & Trends from Zillow & Trulia
- Real Estate Stats & Trends from HouseHunt

The Concept of Tax Advantages & Real Estate Investments



Tax advantages are an important aspect of residential real estate investment. The tax advantages affect the investor both at the time of transfer and as an ongoing consideration connected to the property.

Licensees should be familiar with the basic tax advantages and concepts that affect residential real estate investment, but should be cautious about giving specific tax advice to residential investor clients. All licensees and brokers are advised to use the following disclaimer and statement when asked specific tax ramifications of purchasing any type of real estate:

> ***If you have questions or concerns about the tax consequences of purchasing, selling, transferring or owning real property, you are advised to consult a tax attorney or a professional accountant or tax preparer regarding your situation.***

Allowable Expense Deductions for Owner Occupied Properties

In order to understand the distinctions between owner-occupied properties and investment properties, it is necessary to review the rules which apply to non-investment type residences. On an owner-occupied residence a homeowner only gets a tax deduction for:

- Mortgage interest paid
- Real estate taxes paid
- Some allowable discount points and closing costs

A residential homeowner does not typically get to deduct for insurance, maintenance or improvements.

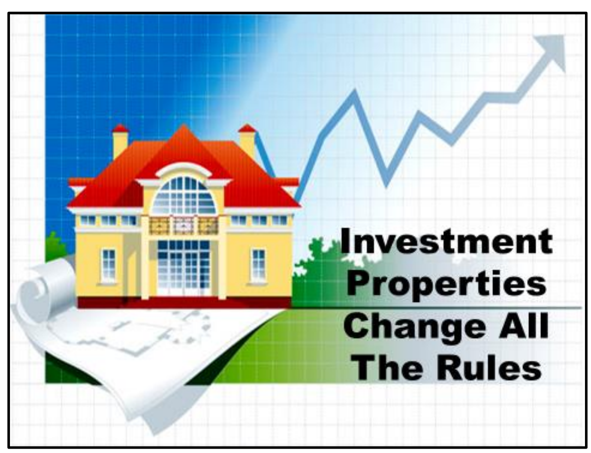
In addition if a homeowner has occupied a property for two out of the last five years prior to sale, then any gain from the sale up to $250,000 for an individual and up to $500,000 for a married couple is excluded from taxation.

Investment properties change all of these rules.

Allowable Expense Deductions for Investment Properties

During the term of ownership investors are able to take deductions for the following expenses associated with the investment property:

- Interest
- Taxes
- Insurance
- Mortgage Insurance
- Supplies
- Repairs and Maintenance
- Mileage
- Postage
- Etc.



Understanding Depreciation

In addition to these substantial benefits an investor is also able to recoup their acquisition cost on the property through a depreciation tax deduction on their returns. Depreciation can be viewed as the annual deduction allowed for wear and tear or the loss of utility of the property. This deduction taken over time is known as depreciation.

We can better understand depreciation if we take it outside of the area of real estate and then reapply the concept inside of real estate.

The I.R.S. allows businesses to take credit for large expenses incurred in the operation of a business. However, the IRS allows only for the deduction of larger business expenses over a period of time. If for example, your business were to buy several thousand dollars worth of computers for use in your business, the IRS would allow you to recover that expense not in a single year, but in the form of depreciation deduction taken over a period of time. **IRS Publication #946** sets forth the rules and a full explanation of the allowance of depreciation on certain items used in business. The theory is that the expense will become a deduction for the investor taken incrementally as the item purchased is used up.

When an investor purchases a piece of residential investment property the IRS considers the purchase price of the structures to be an expense which can be recouped. The cost of the structures simply must be spread over the IRS allowable schedule for such an expense. Historically, the IRS previously allowed investors more latitude in the time frame over which the depreciation was taken and latitude in whether the investor wanted to claim the depreciation expense.

Today the IRS has greatly simplified these rules and requires investors to follow a straight line depreciation schedule. The IRS currently utilizes the following timelines over which the depreciation must be taken:

- **Residential investment property – 27.5 years**
- **Commercial investment property – 38 years**

It is important to remember that the depreciation deduction is only applicable to the purchase cost of the structures and not to the cost of the land. Land is not an allowable depreciation expense under current IRS rules.

The depreciation taken by the investor is subject to recapture by the IRS at the time of sale or transfer of the property. This is one of the reasons why certain investors in the past did not take a depreciation deduction, because historically if the deduction was not taken then the IRS would not seek recapture of the deduction at the time of eventual sale or transfer of the property.

This is no longer the rule. Currently the IRS will recapture the depreciation deduction even if the investor never claimed it on any of their tax returns. Therefore, there is no good reason for an investor not to take advantage of the depreciation deduction, since the IRS assumes that they will have taken it anyhow and calculate the investor's gain on that basis.

The Concept of Capital Gains

Because real estate is an investment, the IRS recognizes that the gain on the investment should be subject to taxation. Individuals who use a home as their primary residence are exempted in most instances from capital gains and may make a profit of up to $250,000 for an individual or $500,000 as a married couple without capital gains tax repercussions. The same is not true for investors who do not meet the primary residence requirement of having lived in the home for 2 out of the past 5 years. Such investors are subject to capital gains tax at the time of transfer of the property.

The rate at which capital gains taxes will be imposed is dependent on whether the investment is classified as a long term or short term capital gain.

Student Notes

The Wall Street Journal's Smart Money website has created a plug-in worksheet for estimating the long term and short term capital gain consequences. You can access the worksheet at:

http://www.smartmoney.com/personal-finance/taxes/the-smartmoneycom-capital-gains-guide-9530/

The Role of 1031 Tax Deferred Property Exchanges

Many investors seek out the advantages of 1031 tax deferred exchange to avoid the capital gains tax consequences of transferring or selling their real estate investments.

There are four basic rules of a 1031 Exchange:

1. The property must be held for investment or productive use in a trade or business
2. The property must be exchanged for like kind property. All real estate is like kind property, with the exception of properties held as personal residences
3. The replacement property must be identified within 45 days after the relinquished property is transferred
4. The exchange must be completed by the earlier of 180 days or the tax return due date

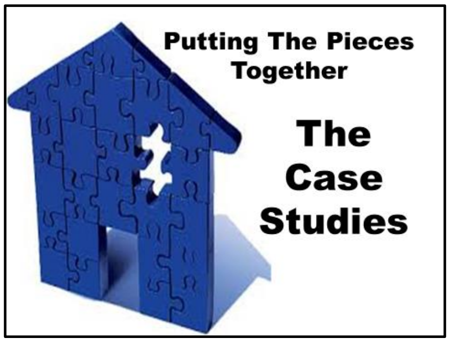
There are numerous advantages to the investor completing a 1031 tax deferred exchange:

- **The capital gains on the exchange is deferred until the eventual sale of the property**
- **Heirs receive a stepped-up basis equivalent to the fair market value**
- **Money that would have gone to pay taxes is available for reinvestment**

There can also be disadvantages to the exchange, which is why a savvy real estate professional always recommends that their investor clients seek out appropriate legal and tax advice. A few of the potential disadvantages are:

- **Future capital gains taxes could be higher**
- **Basis in the replacement property is lower than if purchased outright due to the transfer of basis from the relinquished property**
- **Exchange transactions can be complex and expensive. Investors must be in compliance with strict time limits.**
- **There are tax consequences if the net proceeds are not reinvested**

Student Notes



Practical Applications of Residential Investing

Case Study
The Carolina Rental
Cash on Cash Return

Jason, a Carolina investor, is considering buying a residential property at a list price of $180,000. The investor is planning on putting 20% down and financing $144,000. Because Jason has put 20% down there will be no mortgage insurance on this property. Jason will finance the property with a 30 year fixed rate loan at an interest rate of 6.25%. The taxes on the property are $2,400 per year and property and casualty insurance will cost him $600 per year. The estimated closing costs are 3% of sales price.

Jason has determined that the appropriate market rent that he can charge for this single family residence in his market is $1,500.

Jason is trying to determine his annual cash on cash return on the rental unit.

Determining Cash Flow & Return on Investment

List Price = ______________

A. List Price x _____% Down Payment = ___________

B. List Price x ____% Buyer's Closing Costs = ________

C. Total Cash Outlay (A + B) = ____________

D. Monthly Payment Outlay = ____________

P&I Payment of ______ + Tax ________ = Ins. _______

E. Annualized Outlay (D x 12) = ______________

F. Anticipated Rent _____________

G. Annualized Income F x 12 = ______________

H. Annualized Return (G – E) = ___________

I. Annual Cash on Cash Rate of Return (H ÷ C)

__________ ÷ _________ = _____% Cash on Cash Return

Determining Cash Flow & Return on Investment

List Price = **$180,000**

A. List Price x **20** % Down Payment = **$36,000**

B. List Price x **3** % Buyer's Closing Costs = **$5,400**

C. Total Cash Outlay (A + B) = **$41,400**

D. Monthly Payment Outlay = **$1,136**

P&I Payment of **$886** + Tax **$200** + Ins. **$50**

E. Annualized Outlay (D x 12) = **$13,632**

F. Anticipated Rent **$1,500**

G. Annualized Income F x 12 = **$18,000**

H. Annualized Return (G – E) = **$4,368**

I. Annual Cash on Cash Rate of Return (H ÷ C)

$4,368 ÷ **$41,400** = **10.5%** Cash on Cash Return

Unfortunately, that is where an awful lot of laypeople and first time investors stop their analysis regarding a rate of return. Such an analysis may appear insignificant. Jason is looking at what initially appears to be a relatively small rate of return at 10.5%. In his case it is a difference of only $364 per month. There are lots of unanswered questions.

How would Jason know that the property can be rented for $1,500?

The small $364 that Jason is earning to get to 10.5% fails to take into account a lot of other expenses and items which can decrease his rate of return. He has not figured in any property management fees, repairs, maintenance, vacancies, credit losses or tax consequences. However, Jason is also getting additional rates of return which are often forgot and not factored in as well.

Would you invest in this property based on what we currently have done?

Student Notes

The entire amount of Jason's mortgage payment is being covered by the rental income. Therefore, he is reducing his loan balance and gaining equity with no additional outlay of capital on his part. The equity rate of return should be calculated because it represents an additional return Jason is getting on the property.

Determining Equity Rates of Return

A. Initial Cash Outlay on the Property = _______________

B. Annual Payment = P&I _______ x 12 = ___________

C. Annual Interest = Loan ________ x Rate ____ = _____

D. Principal Reduction (B - C) =

E. Equity Return (D ÷ A) = ___________________________

Jason gained this equity without any additional input of capital on his part. Therefore, contrary to the understanding of most non-investors, the fact that Jason is using the rent proceeds to make a payment is actually giving him a positive rate of return in terms of equity gained. It is another application of the power of leverage.

Determining Equity Rates of Return

A. Initial Cash Outlay on the Property = **$41,400**

B. Annual Payment = P&I **$886** x 12 = **$10,632**

C. Annual Interest = **$144,000** x Rate **6.25%** = **$9,000**

D. Principal Reduction (B - C) = **$1,632**

E. Equity Return (D ÷ A) = **3.9%**

Rounded to 4%

That is still not the end of the investment rate of return story. In addition to gaining a cash on cash return and an equity rate of return, Jason is also earning an appreciation rate of return.

In the market where Jason has purchased the investment property it is currently appreciating at a rate of 6% per year.

Determining the Appreciation Rate of Return

A. Price __________ x ____% Appreciation = __________

B. Appreciation Gain = _______________

C. Original Cash Outlay = ______________

D. Appreciation Return (B ÷ C) = ____________

Student Notes

Adding It All Up
Expanded Rates of Return

Cash On Cash Return __________%

Equity Return __________%

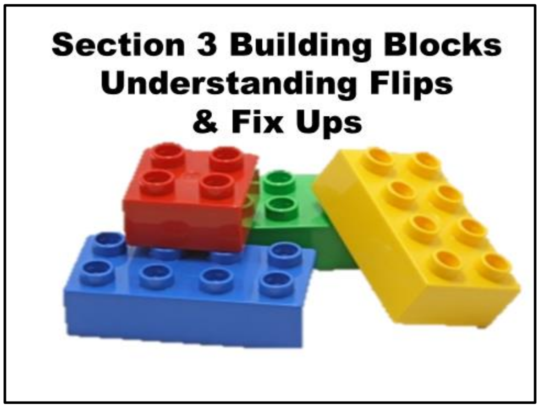
Appreciation Return __________%

Expanded Rate Of Return (1+2+3) __________%

+ Tax Benefit Rate of Return ______________

Now you know why most laypeople underestimate the power of investing in real estate and what exactly the 1% might understand better than most that allows them to increasingly shift the wealth.

Student Notes



Section 3
Understanding Flips
& Fix Ups

Many investors are attracted to investments in residential real estate because of the potential to gain increased rates of return by making improvements or modifications to the property. Essentially an investor has two options when it comes to properties in need of repairs. Some properties and investors employ a Fix & Hold approach and others a Fix and Flip approach.

The considerations in a ***fix and hold scenario*** require a careful analysis of:

- **Purchase Costs**
  - Down payment
  - Closing costs
- **Fix Up Costs**
  - Estimated cost of repairs
  - Including both time and labor
- **Holding Costs**
  - The monthly expenses for the property must be multiplied by the number of months that the repairs will require

By their very definition fix and flip properties anticipate that the investor will have a relatively short holding period for the property. Because of the short holding time there are additional costs involved in a fix and flip scenario that will include resale commissions, resale closing costs and tax implications for the typical investor.

The considerations in a ***fix and flip scenario*** require a careful analysis of:

- **Purchase Costs**
    - Down payment
    - Closing costs
- **Fix Up Costs**
    - Estimated costs of repair
    - Including both time and labor
- **Holding Costs**
    - The monthly expenses for the property must be multiplied by the number of months that the repairs will require.
- **Selling Costs**
    - Commissions
    - Selling closing costs

Student Notes

Case Study Beach Front Bonanza

Susan and two of her friends have located a run-down property located just a few blocks from the ocean in Carolina Beach. They are considering purchasing the property and making some repairs. They are able to get a great deal on the property due to the seller's distressed financial situation. The purchase price for the property is $78,000, but it has a current market value of $110,000. They are going to have to invest $13,000 in property repairs and have estimated their holding costs at $2,732. This amount includes their PITI payment, mortgage insurance and utilities for a four month period.

Can you calculate the equity position of Susan and her friends in regard to the property?

Determining A Net Equity Position

A. Purchase Price = $ ___________

B. Market Price = $ ___________ (Fixed Up)

C. Equity Position = $ ___________ (B – A)

D. Fix Up Costs = $ ___________

E. Holding Costs = $ ___________

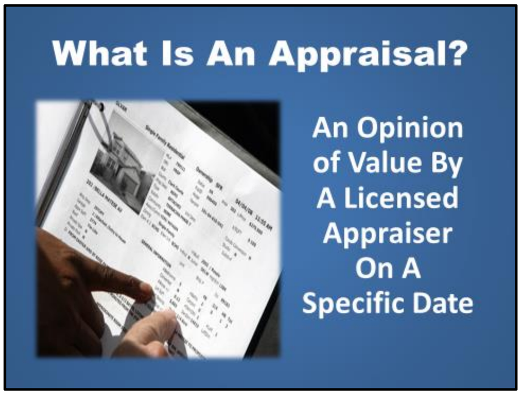
F. Net Equity Position = $ ___________ (C – D – E)

Is It Worth It?

o Rent It?

o Flip It?

Issues of Value & Appraisal



The toughest part of dealing with the analysis of equity and future value is attempting to predict the future worth of the real estate. The person best in a position to determine market value is a licensed appraiser. Appraisers require extensive and intense training and education under the Financial Reform, Recovery and Enforcement Act (FIRREA) of 1989. Their conduct, methods and licensing is regulated by the North Carolina Appraisal Board. .

Unfortunately we often look to appraisers only to determine the "as is" value of real estate, but appraisers also conduct and are qualified to render "subject to" appraisals. Therefore a savvy investor could utilize the services of an appraiser in order to determine the increased value or worth that could be gained through specific repairs or modifications to a property prior to the repairs or modifications being made.

In determining "subject to" values, appraisers apply a number of appraisal principles such as:

A. The Principal of Contribution

    The value that a component part adds or subtracts from value.

B. The Principal of Progression & Regression

    The effect of value caused by the presence of lesser or greater valued properties.

Having a good working relationship with an appraiser and understanding these principals in the repair, modification or improvement of properties can be an invaluable resource for investors.

Issues of Management

The profitable and effective handling of investment properties requires quality management that is in line with Commission Rules and North Carolina State Statutes.

While a real estate license is not required for the management of properties that an investor owns, each investor must analyze and assess their own qualifications, time, resources and commitment to determine whether they are going to attempt self-management of properties or hire a licensed property manager to assist. Property managers perform a wide variety of duties.

Student Notes

Any investor has an important decision to make when it comes to deciding whether or not to hire a professional property management company in regard to the investor's rentals.

Certainly a professional property management company can lessen the strain on the investor in terms of day to day operational issues. However, there are likely to be both up-front costs and monthly fees associated with using a professional property manager. As a general rule most property management companies will end up charging about 10% of the monthly rents and this provides an additional factor that must be considered when analyzing the cash flow of the property.

Some investors choose to manage the property on their own. Here is a list of key questions that you should ask yourself if you are planning on doing your own property management:

1. Are you familiar with Chapter 42 of the General North Carolina Statutes containing the Landlord Tenant Act.

   http://www.ncga.state.nc.us/gascripts/statutes/StatutesTOC.pl?Chapter=0042

2. Are you familiar with the federal Fair Housing Act? Even the ownership of one rental unit falls within the scope of HUD enforcement and a lack of compliance could lead to a Fair Housing violation.

3. Are you willing to engage in the necessary activities to properly advertise any vacancies? This will not only involve creating the advertising, but will also involve the fielding of potential tenant calls and require you to preview the premises with interested tenants.

4. Do you have an appropriate rental application and are you familiar with the legal requirements of what you can and cannot do in regard to collecting and processing information received from tenants?

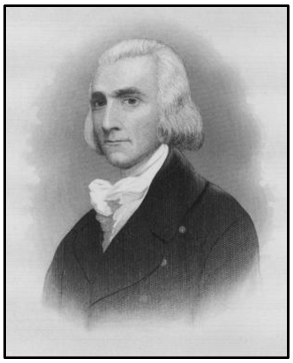
5. Do you have the necessary forms? These would include items such as lease agreements, security deposit agreements and move-in and move-out checklists?

6. Are you ready and willing to respond promptly to calls from occupying tenants? These may involve everything from maintenance and repair issues to complaints about the neighbors.

7. Have you created or do you have access to appropriate record keeping systems?

This course was intended to help licensees better serve and protect the interests of the public. It was created to assist those licensees who own their own investments to understand their obligations and duties. Most of all this course is intended to show the key role that real estate investment plays in the building of wealth and the value of assisting our clients with real estate investments.

The Story of John Jacob Astor



John Jacob Astor was the first American to fulfill the American dream of becoming wealthy through real estate investment. Born to a poor family of German refugees, he came to America in 1784. During the bank panic of 1837 he began saving money and buying properties in New York City. During the course of his life he was able to turn those real estate investments into $110 billion dollars. When his worth is reduced to present day values he still holds the title as the richest man in American history. Today his worth would be twice the worth of Warren Buffet. He did it all with real estate from a starting point of zero.

His great grandson, John Jacob Astor IV, went on to expand that real estate empire and built the Waldorf-Astoria, one of the world's most noted hotels. In the midst of real estate success, John Jacob Astor bought a first class ticket on a luxurious ocean liner. His body was found in the North Atlantic by the cable ship, Mackay Bennett, because John Jacob Astor IV had been passenger on the Titanic.

Like Mr. Astor, neither you nor your clients will get to take your money or investments with you. However, the Astors changed history. Real estate is a powerful investment tool. We should not overlook it. We should advocate investing in real estate and we should be knowledgeable and professional in assisting clients and the public to fully understand the nature of their investments.

Life is too short to not make the best and the most
Of everything that comes your way.

Susan Azevedo

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