## Illustration of the Four Components of "Return on Investment"

## 1 Cash Flow

This first and perhaps most obvious component is "cash flow" - rental income minus expenses - or how much cash ends up in your pocket.

118,800 + Rental Income
32,081 - Operating Expenses
63,997 - Mortgage Payments
22,722 = Cash Flow
337,500 / Downpayment + Closing Costs
$6.7 \%=$ Return on Investment from Cash Flow

## 2 Appreciation

As the value of the property increases, your return on investment increases.
$1,125,000=$ Acquisiton Price
5\% * First Year Appreciation
$1,181,250=$ Value at the end of Year 1.
$56,250=$ Amount of Value Increase
337,500 / Downpayment + Closing Costs
$17 \%=$ Return on Investment from Appreciation

## 3 Equity Build-Up

Even if the property did not increase in value, Equity will increase solely from
paying down the mortgage.
843,750 = Loan Amount at Closing
$834,319=$ Loan Amount at the end of Year 1
9,431 - Equity Build-Up in Year 1
337,500 / Downpayment + Closing Costs
$2.8 \%=$ Return on Investment from Equity Build-Up

## 4 Tax Benefits

One pays less income taxes on a real estate investment than on other investment vehicles.

86,719 = Cash Flow Before Loan Payments (rents less expenses)
23,906 - Depreciation (assumes 15\% land, 30 year recovery)
54,566 - Mortgage Interest
8,246 = Taxable Income Year 1
6,597 Less 20\% Exclusion for LLC Ownership under new tax law
37\% * Marginal Tax Rate
2,440.87 = Federal Income Tax
2,441 Federal Income Tax
22,722 / Cash Flow
10.7\% = Effective Tax Rate on This Investment
$8,407=$ Tax if Cash Flow came from a non-preferred investment vehicle
2,441 - Tax from this preferred investment vehicle.
5,966 = Income Tax Savings
1.8\% Return on Investment from Tax Savings

Total / Summary

| 1: | 22,722 | Cash Flow |
| ---: | ---: | :--- |
| 2: | 56,250 | Appreciation Year 1 |
| 3: | 9,431 | Equity Build Up Year 1 |
| 4: | 5,966 | Tax Savings Year 1 |
|  | 94,369 | Total Return from this Investment |
|  | 337,500 | Downpayment + Closing Costs |
|  | $28.0 \%$ | Total Return from this Investment |


| IIIustration of Internal Rate of Return over a 10-Year Holding Period PORTFOLIO OF 4 RENTAL HOMES |  |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Purchase Price | 1,125,000 | 2025 | $\underline{2026}$ | 2027 | 2028 | 2029 | 2030 | $\underline{2031}$ | $\underline{2032}$ | $\underline{2033}$ | 2034 |
| Annual Rent | 4.0\% | 118,800 | 123,552 | 128,494 | 133,634 | 138,979 | 144,538 | 150,320 | 156,333 | 162,586 | 169,089 |
| Vacancy | 3.0\% | 3,564 | 3,707 | 3,855 | 4,009 | 4,169 | 4,336 | 4,510 | 4,690 | 4,878 | 5,073 |
| Effective Income |  | 115,236 | 119,845 | 124,639 | 129,625 | 134,810 | 140,202 | 145,810 | 151,643 | 157,708 | 164,017 |
| Expenses | 4.0\% | 32,081 | 33,365 | 34,699 | 36,087 | 37,531 | 39,032 | 40,593 | 42,217 | 43,906 | 45,662 |
| Exp as a percent of Annual Rent |  | 28\% | 28\% | 28\% | 28\% | 28\% | 28\% | 28\% | 28\% | 28\% | 28\% |
| Exp per unit | 4 | 8,020 | 8,341 | 8,675 | 9,022 | 9,383 | 9,758 | 10,148 | 10,554 | 10,976 | 11,415 |
| NOI | 86,719 | 83,155 | 86,481 | 89,940 | 93,538 | 97,279 | 101,170 | 105,217 | 109,426 | 113,803 | 118,355 |
| Debt Service | \$ 5,333 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 | 63,997 |
| $16.4 \%$ Internal Rate of Return |  |  |  |  |  |  |  |  |  |  |  |
| NOI |  | 83,155 | 86,481 | 89,940 | 93,538 | 97,279 | 101,170 | 105,217 | 109,426 | 113,803 | 118,355 |
| Less Interest |  | 54,566 | 53,934 | 53,261 | 52,542 | 51,774 | 50,956 | 50,082 | 49,151 | 48,156 | 47,095 |
| Less Depreciation |  | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| Taxable Income to Individuals |  | $(1,412)$ | 2,546 | 6,679 | 10,996 | 15,505 | 20,214 | 25,135 | 30,275 | 35,646 | 41,259 |
| Pass Thru Entity | 20\% | 282 | (509) | $(1,336)$ | $(2,199)$ | $(3,101)$ | $(4,043)$ | $(5,027)$ | $(6,055)$ | $(7,129)$ | $(8,252)$ |
| Taxable Income | 0 | $(1,129)$ | 2,037 | 5,343 | 8,797 | 12,404 | 16,171 | 20,108 | 24,220 | 28,517 | 33,008 |
| Tax @ * | 37\% | (418) | 754 | 1,977 | 3,255 | 4,589 | 5,983 | 7,440 | 8,961 | 10,551 | 12,213 |
| 14.0\% Internal Rate of Return |  |  |  |  |  |  |  |  |  |  |  |
| Purchase | 1,125,000 |  |  |  |  |  |  | Assume a Sale at End of Year 10 |  |  |  |
| L-V | 75\% |  |  |  |  |  |  | Annual Rent Roll |  |  | 169,089 |
| Loan | 843,750 |  |  |  |  |  |  | GRM |  |  | 9.5 |
| Down Payment | 281,250 |  |  |  | annual appreciation 3.6\% |  |  | Price |  |  | 1,601,226 |
| Cap Improvement | - |  |  |  |  |  |  | Sale Costs |  | 6\% | 96,074 |
| Closing Costs | 39,375 |  |  |  |  |  |  | Less: Basis |  |  | 825,000 |
| Initial Investment | 320,625 |  |  |  |  |  |  | Gain |  |  | 680,152 |
| Rate | 6.50\% |  |  |  |  |  |  | Tax @ |  | 20\% | 136,030 |
| Term | 30 |  |  |  |  |  |  | Mortgage Bala |  |  | 715,299 |
| P\&I | \$5,333.07 |  |  |  |  |  |  | Sale Proceeds Before Tax |  |  | 789,854 |
|  |  |  |  |  |  |  |  | Sale Proceeds After Tax |  |  | 653,823 |
| Mortgage Amortization |  | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| 843,750 | Beg Bal | 843,750 | 834,319 | 824,257 | 813,520 | 802,065 | 789,843 | 776,802 | 762,887 | 748,041 | 732,200 |
| 6.50\% | Prin | 9,431 | 10,062 | 10,736 | 11,455 | 12,223 | 13,041 | 13,914 | 14,846 | 15,841 | 16,902 |
| 30.0 | Int | 54,566 | 53,934 | 53,261 | 52,542 | 51,774 | 50,956 | 50,082 | 49,151 | 48,156 | 47,095 |
| 5,333 | Bal EOY | 834,319 | 824,257 | 813,520 | 802,065 | 789,843 | 776,802 | 762,887 | 748,041 | 732,200 | 715,299 |
| Cost Recovery / Depreciation |  | 1,125,000 | 1,125,000 | Building | 80\% | 900,000 | Land | 20\% | 225,000 | Life | 30 |
|  |  | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| Basis |  | 1,095,000 | 1,065,000 | 1,035,000 | 1,005,000 | 975,000 | 945,000 | 915,000 | 885,000 | 855,000 | 825,000 |
| * Tax rate of $35 \%$ applies to income of $\$ 200,001$ to $\$ 500,000$ for singles; $\$ 400,001$ to $\$ 600,000$ for married filing jointly. Marginal rate above $\$ 500 \mathrm{k} / \$ 600 \mathrm{k}$ is $37 \%$. |  |  |  |  |  |  |  |  |  |  |  |

