



Example 13.3: Cash Flow Properties vs. Appreciation Properties

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Introduction:

This article aims to (1) assist you in understanding the Google sheet “Book Example 13.3”, an example provided in my book “Passive Profits: The Turnkey Rental Investor’s Guide”, and (2) discuss the concepts Example 13.3 is designed to demonstrate.

For (1) I have intentionally left the ranges in the Google sheet unprotected so that you can adjust the inputs to model various scenarios and access the calculations in the output section.

For (2), example 13.3 aims to illustrate several important concepts. Long-term rentals come at different price points, rental rates, and expenses; that is, their financials can vary widely. To facilitate discussion and understanding, it's useful to categorize long-term rental properties into two groups based on the financial spectrum: cash flow and appreciation properties. Both types can produce leveraged ROIs greater than 20%, where the ROI of the appreciation property typically exceeds that of the cash flow property, albeit at the cost of increased risk. However, the total profits are distributed differently across the four returns – cash flow, appreciation, loan paydown, and tax savings from depreciation. Understanding these differences allows for tailoring your portfolio of rentals to meet various goals and objectives. Thus, cash flow and appreciation

properties can be considered as two distinct building blocks for constructing and modifying a portfolio of rental properties.

Objectives of Example 13.3:

1. Provide the financial performance of two different price-point properties.
2. Use the financial performance of these properties to define cash flow and appreciation properties from a financial perspective.
3. Illustrate how the total return from each property type, aggregated from cash flow, appreciation, loan paydown, and tax savings from depreciation, is distributed differently across the four returns.
4. Discuss how the building blocks – cash flow and appreciation properties – can be used to construct a portfolio of rental properties and modify an existing portfolio of rental properties.

The Google Sheet: “Book Example 13.3”

The Google sheet contains two tabs: Instructions and Property Financials. The Instructions tab offers a brief description and some guidance. The Property Financials sheet contains all the inputs and outputs.

User Inputs:

User inputs are indicated by black fill with white font. Below is a description of the inputs followed by the values used in the example.

Purchase Price: The price of the properties. The selected purchase prices represent actual properties.

Loan-to-Value Ratio: The ratio that describes how much money the bank loaned compared to the property's value.

Mortgage Interest Rate: The interest rates for the mortgages.

Term: The duration of the mortgages: 15, 20, 30 years.

Closing Costs: The expenses incurred during the acquisition of the property.

Rental Rate: The monthly rent for the property.

Appreciation Rate: The annual appreciation rate for the properties. I selected rates of 2% and 5% to represent properties below and above the historical average of 3.8%.

Tax Bracket: Your tax rate according to IRS brackets.

Property Management Fee: The fee for managing your property.

The inputs used in Example 13.3 are displayed below in Table 1.

Table 1. Inputs used for Example 13.3.

	Cash Flow Property	Appreciation Property
Purchase Price	\$150,000	\$350,000
Loan-to-Value	80%	80%
Interest Rate	5%	5%
Term, years	30	30
Closing Costs	3%	3%
Rental Rate	\$1,300	\$2,300
Appreciation Rate	2%	5%
Tax Bracket	24%	24%
Property Management Fee	8%	8%

Outputs:

Outputs are indicated by white fill with black font. Below is a description of the outputs followed by the output for the input values used in Example 13.3.

Mortgage: The monthly mortgage payment.

Interest: The portion of the monthly mortgage payment that goes towards interest.

Principal: The portion of the monthly mortgage payment that goes towards the principal.

Insurance: The annual cost of property insurance, based on actual properties.

Property Tax: The annual cost of property taxes, based on actual properties.

Property Management Expense: The annual cost of managing the property.

Depreciation Expense: The annual depreciation expense for the properties.

Investment Funds: An estimate of the cost to purchase the properties, used to calculate ROI.

Financial State:

The financial state is when the finances of a system are summarized into total asset value, total debt, total revenue, and total expenses, providing a concise summary of the system's financial status.

Revenue: The annual revenue generated or projected for the properties.

Expenses: The total annual expenses incurred from operating the properties, categorized into Fixed and Variable Expenses, Depreciation, and Income Tax.

Fixed Expenses: These are constant expenses including mortgage interest, property tax, property insurance, and property management fees.

Variable Expenses: The aggregate of unpredictable expenses such as repairs, maintenance, and cleaning.

Depreciation: The annual depreciation expense allocated for the property.

Taxable Income: The estimated income to be reported to the IRS.

Total Expenses: The aggregate expenses of the property, combining fixed and variable expenses, depreciation, and income taxes.

Assets: The current value of the property after considering appreciation.

Debt: The aggregate debt associated with the properties, which encompasses the mortgage balance and any other outstanding loans.

The Four Returns:

The four returns represent the distinct sources of profit from a rental property, comprising cash flow, loan paydown, appreciation, and tax savings from depreciation.

Cash Flow: The annual estimate of cash flow and the corresponding ROI, factoring in income tax expenses.

Loan Paydown: The annual benefit from paying down the mortgage.

Appreciation: The increase in the property's value.

Effective Tax Bracket: The actual percentage of income tax applied.

Total: The cumulative return for the property, calculated as the sum of cash flow, loan paydown, and appreciation.

ROI: The Return on Investment, indicative of the annualized financial return from the properties.

Table 2. Outputs for the inputs used in Example 13.3. Outputs are per month unless specified otherwise.

	Cash Flow Property	Appreciation Property
Mortgage	\$644	\$1,503
Interest, 1st month	\$500	\$1,167
Principal, 1st month	\$144	\$336
Insurance	\$65	\$128
Property Tax	\$200	\$513
Property Management Fee	\$104	\$184
Depreciation, annual	\$4,495	\$10,487
Investment Funds	\$34,500	\$80,500

Table 3. Financial State for each property. Values are annual.

	Cash Flow Property	Appreciation Property
Revenue	\$15,600	\$27,600
Fixed Expenses	\$10,388	\$23,814
Variable Expenses	\$0	\$0
Depreciation	\$4,495	\$10,487
Taxable Income	\$718	-\$6,701.38
Total Expenses	\$15,055	\$32,693
Assets	\$153,000	\$367,500
Debt	\$120,000	\$280,000

Table 4. The Four Returns for each property. Values are annual.

	Cash Flow Property		Appreciation Property	
	Dollars	ROI	Dollars	ROI
Cash Flow	\$3,442	10.0%	-\$345	-0.4%
Loan Paydown	\$1,770	5.1%	\$4,131	5.1%
Appreciation	\$3,000	8.7%	\$17,500	21.7%
Effective Tax Bracket	3.3%		0.0%	
Total	\$8,121	23.8%	\$21,286	26.4%

Discussion:

Let's revisit the objectives listed at the beginning of this article:

2. Define cash flow and appreciation properties from a financial perspective based on the performance of these properties.

Cash Flow Property: Leveraged ROI > 20% and Taxable Income > \$0

Appreciation Property: Leveraged ROI > 20% and Taxable Income < \$0

3. Illustrate how the total return from each property type, aggregated from cash flow, appreciation, loan paydown, and tax savings from depreciation, is distributed differently across the four returns.

Cash Flow Property:

- 41.9% of the total return comes from cash flow
- 21.6% of the total return comes from loan paydown
- 36.5% of the total return comes from appreciation
- The taxable income was \$717, representing a 3.3% effective tax rate

Appreciation Property:

- -1.6% of the total return comes from cash flow
- 19.4% of the total return comes from loan paydown
- 82.2% of the total return comes from appreciation
- The taxable income was -\$6,701, representing a 0.0% effective tax rate

4. Discuss how the building blocks – cash flow and appreciation properties – can be utilized to construct a portfolio of rental properties.
 - Evaluate your personal finances and determine whether you can or want to mitigate the risk of starting your portfolio with appreciation properties.
 - For most, including myself, the focus has been on purchasing cash flow properties.

- Monitor the financial state of your portfolio and make projections for the following fiscal year. Over time, your taxable income will likely increase.
- If your cash flow is insufficient to hedge the additional risk that comes with purchasing an appreciation property, opt for a cash flow property, even if you are projecting taxable income.
- If you are projecting significant appreciation, for example, an upcoming expansion in the market, and your portfolio can mitigate the risk, then consider purchasing an appreciation property. Here, your goal is to increase the asset value of your financial state as rapidly as you can, while still maintaining safety.
- If you are projecting a market slowdown and wish to add a property, opt for a cash flow property.

These are some generalized strategies on how to build and modify your portfolio based on market conditions, your financial state, and how well properties fit into your portfolio. There are certainly many more criteria you could consider.

Conclusions:

Example 13.3 provides a numerical comparison for the first year to highlight the broader principles underlying successful rental property investing. Future examples will extend this analysis to subsequent operational years. It emphasizes the importance of understanding the financial nuances and strategic potential of each property type within the context of portfolio management and investment objectives.

Investors are encouraged to view cash flow and appreciation properties not as binary opposites but as complementary components of a robust and balanced investment strategy. By carefully assessing and integrating these property types, investors can create a portfolio that not only withstands market fluctuations but also prospers across different economic cycles.

Ultimately, the insights gained from this analysis enable investors to navigate the complexities of rental property investing with increased confidence and precision. Whether focusing on cash flow for immediate income or leveraging appreciation for future gains, adopting a nuanced approach to portfolio composition is essential. As the real estate market continues to evolve, investors' strategies should also adapt, always informed by thorough analysis, diligent financial management, and a clear understanding of their investment goals.

In conclusion, Example 13.3 acts not only as a practical tool for financial analysis but also as an impetus for strategic thinking and portfolio optimization in the ever-changing landscape of rental property investing.

Thanks for reading,

-Scott

Further Reading:

1. My book, "Passive Profits: The Turnkey Rental Investor's Guide".
<https://scottastanfield.com/book/>
2. My blog: <https://scottastanfield.com/blog/>
3. My reference articles: <https://scottastanfield.com/tools-and-services/>