THE NON-SCARINESS OF CAPEX:

FORECASTING, DEPRECIATING, CASH-FLOWING!

SparkRental

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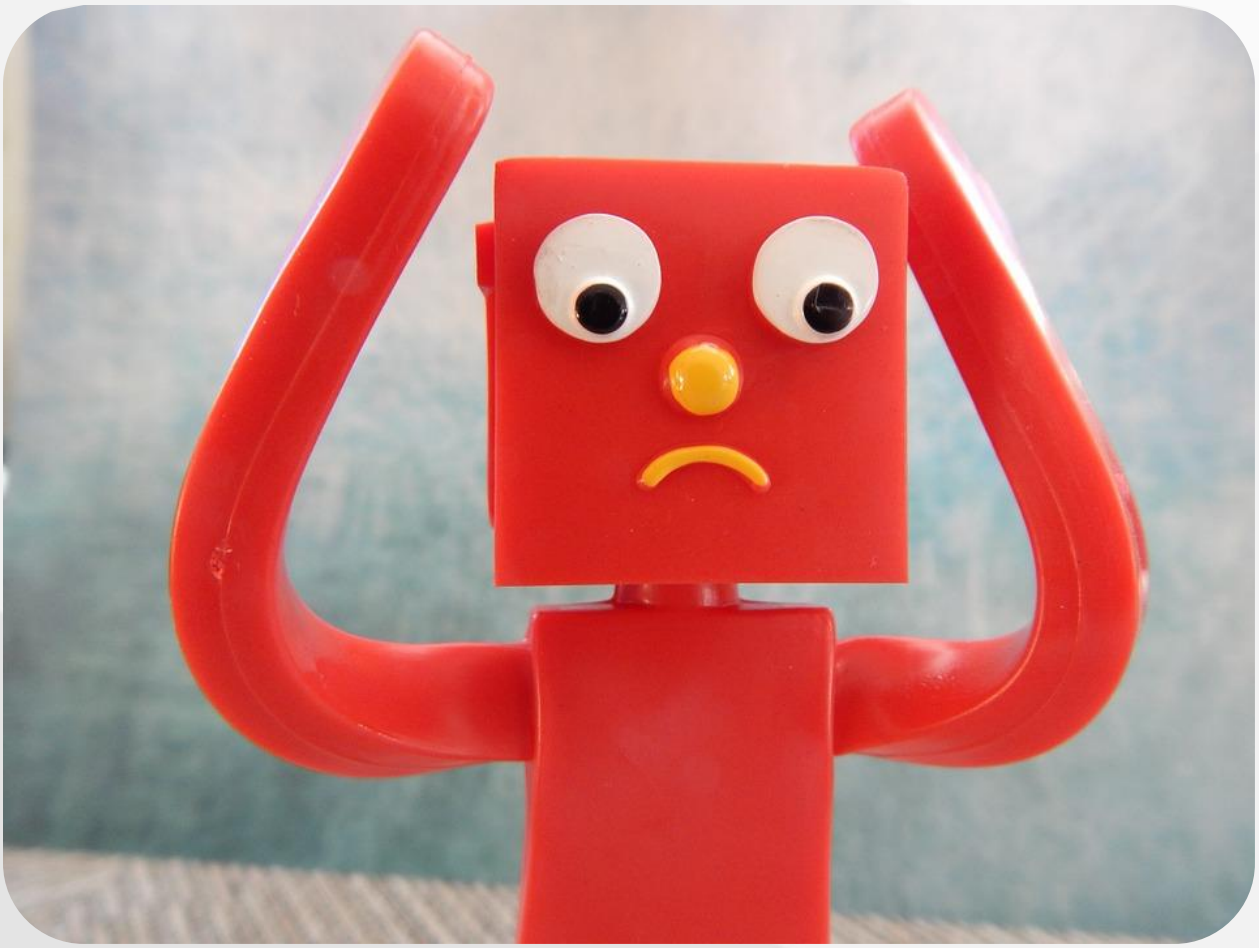


I know, I know, you don't like math. We'll keep it manageable.

Landlords lose money on their rental properties for many reasons, but the most common is that they failed to factor in all the costs of owning, managing and maintaining the property before they bought it.

Far too many landlords just subtract the monthly mortgage bill from the rent, and even those that factor in vacancies, maintenance, property management fees, accounting costs and the likelihood of rent default are still getting it wrong.

Let's beat up on a landlord named Bill to illustrate this point. Bill bought a property that leases for $1,000/month, and his mortgage payment is $750/month. Bill thinks he's a genius who's about to earn $250/month.

In reality, Bill is in big trouble. He has other expenses, before we even get into CapEx:

Vacancy Rate: 10% = $100/month

Maintenance: $1,000/year = $83.33/month

Property Management: 8% = $80/month

Accounting, Bookkeeping, Administrative & Misc: $400/year = $33.33/month

Before CapEx, Bill's property will cost him an average of $1,046.66/month. We'll be generous and give Bill the benefit of the doubt that his property taxes and insurance are included in his mortgage payment of $750. But he's still cash flow negative.

And the news gets worse from here for our simple-minded friend Bill.

So What Is CapEx?

CapEx, or capital expenditures for non-finance-nerds, are large-scale property upgrades and replacements. They only need to be made rarely, but still on a predictable basis, since everything in a home eventually needs replacing.

For example, the roof may only need replacing every 20 years… but it costs a lot of money. And then there are furnaces, air conditioning condensers, flooring, framing, electrical systems, plumbing systems, HVAC and ductwork, kitchens, bathrooms, windows… every component in every home needs to be replaced or updated, and on a largely regular schedule.

Landlords are always taken by surprise when a furnace breaks, or the roof needs replacing, or the AC condenser drops out. Last year, it was the roof, and after shelling out the $5,000 to replace it, Bill consoled himself by saying "Well, this was an off year because of that roof bill, but next year will be better."

But this year, the furnace broke, and he's howling in frustration after the $2,500 bill to replace it.

Bill is worse off than we originally thought even a few paragraphs ago. Here are some invented numbers to illustrate the point:

Capital Expense	Replacement Cost	Lifespan (years)	Annual Cost	Monthly Cost
Furnace	$2,500	15	$166.67	$13.89
Water Heater	$1,500	10	$150.00	$12.50
Roof	$5,000	20	$250	$20.83
Kitchen	$15,000	20	$750.00	$62.50
Each Bathroom	$7,500	20	$375.00	$31.25
Other Appliances	$2,000	20	$100	$8.33
Windows	$5,000	40	$125.00	$10.42
Plumbing	$5,000	30	$167	$13.89
Electrical	$10,000	30	$333	$27.78
Framing	$15,000	50	$300	$25.00
Foundation	$10,000	50	$200	$16.67
Parking/Driveway	$5,000	30	$167	$13.89
Total:			**$2,767.00**	**$230.56**

Hard Truths Are Easier Than Hard Lessons

"But," you ask, "didn't I already budget for maintenance?"

Maintenance comprises costs you incur between each tenancy, and mild repairs during it. New paint, new carpets, trimmed landscaping, patching a small roof leak. It doesn't involve replacing the entire roof.

Capital expenditures, and other unaccounted-for expenses, are why so many landlords fail. Rental properties are a lot of work to maintain, manage, and financially care for, and most landlords don't fully grasp all of the work and expenses involved.

Let's break down an imaginary rental unit's monthly budget:

Mortgage (P&I): $500

Property Taxes: $100

Insurance: $75

Property Management (in this example: 10%): $150

Vacancy Rate (example: 8%): $120

Accounting/Bookkeeping: $25

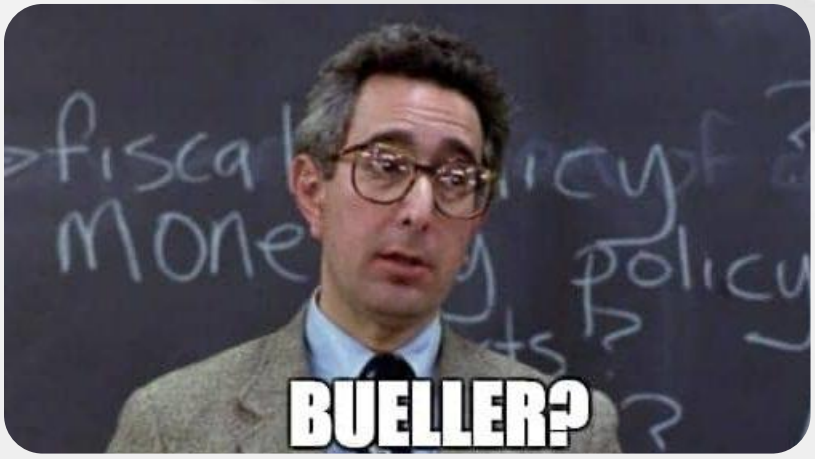
Regular Maintenance: $100

CapEx: $200

Total Expenses: $1,370

Rent: $1,500

<u>Monthly Cash Flow: $130</u>



The Numbers May Be Ugly, But They Don't Lie

A When you think about the above, it's actually pretty terrifying. Where is anyone supposed to find an investment property that rents for $1,500 but will only cost $500/month in mortgage payments?

There are a few answers to that question. One answer is that rents are not fixed in stone; they rise or fall depending on the condition of the property, the amenities offered, etc. Another is that there are additional ways to earn money from rentals, beyond rents.

Also remember that costs aren't fixed, either. Perhaps aggressive tenant screening will cut down on your vacancy rate and turnovers? Maybe you can reduce your turnovers with a two- or three-year lease agreement, to cut down on all the nasty maintenance, vacancy, labor and other expenses that come with turnovers?

As you find ways to trim expenses and boost revenues, you may find you can afford to spend closer to $700 on the mortgage, even while your competitors can only spend $500 on it.

But the important point is that this is why it's so hard to find excellent investment properties. If it were easy, everyone would be doing it, right?

CapEx & Taxes: Depreciate!

When Tim bought the property, he used an FHA loan, which requires only a 3.5% down payment. His mortgage payment is presently $951, at a lean 3.75% interest rate.

Repair costs are deducted, when it comes time to do your taxes. You patched a roof leak last year? It's deducted directly from your taxable profits.

But what if you replace the entire roof?

It's a different story entirely.

As a landlord and real estate investor, you probably know that you can claim the paper expense of depreciation, on the building itself. If you bought a rental property for $100,000, and the assessed value of the land is $25,000 and the building $75,000, then over the next 27.5 years you can claim a loss on the building's value of 1/27.5th each year.

You don't actually lose that money, but you can claim it as a loss when you prepare your taxes.

Here's the catch though: capital expenditures extend the life of your building. So the money you spend on CapEx must also be depreciated over 27.5 years.

Let's run a quick example: the new roof costs you $5,000. You can't write off that cost all at once, on this year's tax return.

But for each of the next 27.5 years, you can write off 1/27.5th of that cost. That comes to $181.82/year that you can write off for the next 27.5 years.

Become a Cash Flow Connoisseur

TBefore buying a rental investment, get as many details as you can about when each and every system, appliance and component of the property was last replaced or updated. Get copies of receipts and invoices if you can. That will give you a better sense of when some of these chickens will come home to roost.

And, of course, if you're renovating the property you'll know exactly when these systems have been replaced. But you should still calculate the monthly cost of CapEx and include it in your ROI calculations.

The good news? It doesn't take long to learn how to accurately forecast rental cash flow, so you'll be able to quickly dismiss losers and identify winners, as you shop for your investment portfolio.♦