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Thinking you missed the best rates/ cash flows?

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The recent negative moment in the Mortgage Backed Securities has evidenced a 1% (at times higher) jump in rates. A move such as this can force a pause for many investors who believe they may have gotten into the game too late and missed the best rate options, losing out on best possible cash flows. Recently speaking with an investor he shared significant concern for the difference he was seeing when attempting to close on another purchase this year with a 1% increase in rate from late 2017.

4th quarter 2017 he signed purchase agreements on 2 separate properties in the same neighborhood. They were nearly identical in all aspects…Price, Taxes, Insurance, Rental income etc, however one was completed and closed in Dec 2017 and the second was closing in April due to rehab timing and unforeseen events.

Cancellation of the second contract was being considered as he was “Losing $600.00 per year in income” based on the difference in the payment from one property to another. Pausing I had to ask if he was truly losing that much. Had he consulted his CPA and consider the difference the tax deduct-ability will make? After all he is the "CEO" of his real estate investment firm and needs to consider all ways his business can increase the bottom line. Not all bottom line increase comes from cash flow and we need to analyze the net return/ cost.

Keeping it simple let’s use basic numbers to put this to the test.

December 2017	April 2017
$100,000.00 Price	$100,000.00 Price
$80,000.00 Loan	$80,000.00 Loan
$1000.00 Rent	$1000.00 Rent
4.75% Rate	5.75% Rate

$417.32 P&I	$466.86 P&I
$57.00 Insurance	$57.00 Insurance
$91.66 Property Taxes	$91.66 Property Taxes
$100.00 Prop Management Fee	$100.00 Prop Management Fee
$665.98 recurring monthly Expense	$715.52 recurring monthly

$715.52 (April example)

-$665.52 (December Example)

$ 49.54 per month or $594.48 per year difference in net cash flow

So he is correct there is a difference of nearly $600.00 per year in revenue or cash flow brought in. But one has to consider, if your revenue drops by $594.48 per year so does the taxes you would pay on that income. Being that he indicated a 30% tax bracket (Federal) that is a drop in taxes by $178.34 (30%of $594.48) which means that your net after-tax cash flow difference is no longer $594.48 is now down to $416.14.

Since the drop in income was caused by a 1% increase in rate, let's look at the additional interest expense that is paid. The simplest calculation to estimate this dollar amount increase in interest would be to determine what 1% of $80,000.00 is. That is $800.00. The increased interest paid provides an increased tax deduction of $800.00 per year. This interest figure does diminish over the amortization term. This is a simplified illustration, yet still effective as the interest deduction remains higher.

Being that I am not a CPA and not one to advise on taxes (ALL should seek advice of a CPA and Attorney), so I asked a CPA partner of mine to look at this math and give me some further details to consider. She indicated I should apply the same 30% math to calculate additional tax deduction you will get by paying additional $800 of interest expense. 30% of $800.00 = $240.00. Add $240.00 (30% of 800 interest) and $178.34 (30% of $594.48 cash flow difference) and you get $418.34. Is it still an appx $600.00 Loss on revenue? Given the state he was in there is also a 10% state tax we can employ. That is $59.48 less paid on lower cash flow and $80.00 additional deduction for interest. So our simple tax adjust equation is-

$418.34 Federal Tax adjustment ($178.34 + $240.00 above)

$139.48 State Tax adjustment ($59.48+ $80.00 above)

$557.82 Tax savings adjustment

$594.48 initial perceived loss

-$557.82 Tax adjustment (Fed and State)

$ 36.66 per year or $3.55 per month difference between 4.75% Rate and 5.75% rate.

Bottom line, rate may not have much to do with it when you are part of a highly tax favored asset class like Real Estate. You should take the time to figure out where you fit on this and if the increasing rates are truly breaking your deal after applying this kind of math. It may be that you are investing in the wrong asset. Additionally any lender who wants to use their rates as their single great selling point doesn't appear to be much of a partner in your business. Could it be that they are merely interested in closing and getting themselves paid or lack the ability to contribute more than just processing a loan to your business?

You are the CEO of your business and we need to focus on the big picture. Don't get hung up rate changes and small obstacles as the net effect/ impact is very minimal to your bottom line. Seriously, will you remember any of these numbers tomorrow or next year? Most of the time, the lost opportunity is what truly cost you down the road. Targeting your attention on the right team of professionals to add to your board table of trusted advisers should be your most urgent focus.

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