Chapter 3: Foundational Knowledge

Real estate, like dentistry, uses another language from our day to day speech. For you to be able to understand everything we will be talking about in successive chapters, I need to make sure that you have the same foundational knowledge I do. With that said, all financial decisions need to be made with the appropriate professionals, especially when we are talking about tax treatment and asset structure. You need to involve a professional whose only job is knowing these things and can advise you the best. The below is a summary of my understanding from years of study and networking with these experts in the field.

Also, most key terms will cross between different vehicles of real estate. For example, I define real estate mortgages in the Hard Money Lending section, but they are applicable to every real estate transaction. The terms are placed where I found them to be most applicable.

Business Structure:

1. Legal
    a. Sole Proprietorship
        i. This is a single person who owns the business. No separate legal entity is created. Sole proprietors are exposed to 100% liability, meaning any lawsuit puts all the sole proprietor's personal assets at risk. Do not use this structure.
    b. LLC
        i. A structure that is formed to create a business, limit personal liability, and pass through taxation is available (all income and expenses pass through personally)
    c. Corporation
        i. A structure that is formed for businesses with substantial revenue and complex ownership arrangements and taxation vehicles. You can think of this as a company that will become Apple or Google. Generally not used at the dentist or normal real estate investor level.
    d. GP/LP
        i. General Partnership and Limited Partnership. This is a business owned by multiple people. In a GP, all parties are typically owner-operators. In a LP, there is one or more general partners that take on all the management of the property and sometimes personally guarantee the loans, and in return raise funds from Limited Partners, who take on no management or ever personally guarantee the loan, but bring all the capital generally.
2. Tax Treatments
    a. Disregarded Entity - Passthrough
        i. All profit, losses, deductions, and credits are passed on to the owner(s). Most small businesses start this way until it becomes more advantageous to elect a tax treatment as an S-corp or C-corp
    b. S-corp
        i. Similar to a pass through, but generally has a small amount that the owner takes as a wage, upon which he pays social security and medicaid taxes. The remaining money will be taken as distributions, but not subject to social security or medicaid taxes
    c. C-corp
        i. C-corps have double taxation. They pay taxes on profits and distributions. Why then would anyone use a C-corp? Generally, if you are planning to keep the money in the business and reinvest into the business your first taxation is lower than your normal personal effective taxation rate. So you can grow money in the business at essentially a deferred tax rate, as long as you don't take a distribution.

Residential Real Estate:

1. Cash on Cash
    a. This is a fraction, which is then translated to a percentage. On the top of the fraction is the dollar return you receive after all expenses on an investment annually. On the bottom of the fraction is the dollar amount you invested. If you received $1,000 back annually for investing $10,000, you would simply divide do $1000 / $10,000 which equals 0.1 and then convert that resulting number into a percentage and you would get a 10% cash on cash. Some people write this as 10% CoC.
2. Cash Flow
    a. All investors define this differently. Most people define it as monthly income minus all expenses, including debt service. However, in residential real estate, that is wrong in my opinion. This is due to the fact that some money needs to be earmarked for large repairs (Flooring, HVAC, Roof) down the road, even if technically you haven't yet paid it yet.
3. Rehab
    a. Remodeling. Some people say remodel, some people say rehab. They mean the same thing.
4. ARV
    a. After Repair Value. This is what the value of a property will be when all fixed up or stabilized.
5. Value Add

   a. This is when a property has potential to be worth more with some rehab done. The value add portion must deliver more equity to the property than rehab costs to be even considered.

6. Turnkey Property
   a. A ready-to-rent unit
7. Proforma
   a. Financial Projection of income and expenses
8. Comps
   a. Comparable Sales. This is a property that is similar in size, shape, and location to the subject property. Appraisers, realtors, and investors use this to determine the fair price of a property being bought, sold, or under contract.
9. Deferred Maintenance
   a. This is when a building has not gotten the repairs or regular maintenance it needs. It could mean that it needs a new roof, new HVAC, has structural issues, etc
10. Equity
    a. This is either inherent value that you have in a property or gained value that you will create in a property
11. Single Family
    a. This is a single house. Often abbreviated as SFH or SFR (Single Family Residence)
12. Duplex/Triplex/Quadplex
    a. This is a single house, but it has separated sections that do not connect. So one roof, but two dwelling units within the house is a duplex. Three = triplex and four = quadplex or fourplex. Note that townhouses can seem like they share walls and are connected and thus duplexes/tri/quadplexes but actually if you look at their roofs, they generally will not be one continuous roof. This helps separate the properties, even though they are connected
13. Multifamily
    a. This is a true apartment. Apartments technically start at 5 dwelling units under one roof but can expand to hundreds or even thousands under one roof. Some people call duplex to fourplex a multifamily, but I differentiate it as 5 units and above.
14. Conventional Loan
    a. This is a loan that is given to you, personally. It will never have an LLC name or business name. It is almost always amortized over 30 years. It generally has the lowest rate of all loans, as you are a guarantor of it personally
15. Commercial Loan
    a. This is a loan that a bank gives your company with the intent of using it for business or investment purchase
    b. A commercial loan can be given on a single family house.
16. DSCR Loan
    a. A debt service coverage ratio loan you can get on LLC-owned properties that give a 30 year fixed rate. Normally only properties owned in your name get a 30 year fixed rate
17. Amortization
    a. The number of years that your loan payment is based upon. Note: This is different from how long your loan may be fixed
18. Fixed Rate Term
    a. How long your loan will stay at a given interest rate. A very common structure for a commercial loan is a 5 year fixed rate on a 20 year amortization
19. Variable Rate Term
    a. How long your interest rate will “float” or be variable. Generally a lower minimum and an upper maximum rate is established
20. Balloon
    a. When a payment comes fully due, even though your amortization is generally longer. For example a loan may come due at 15 years, but based on an amortization of 25 years.
21. Maturity
    a. This is when a loan comes due or you reached the end of your amortization period and you are about to pay it off. Used interchangeably with balloon. The key difference is a balloon will always have money that still needs to be paid at the end of it, whereas maturity can mean the end of the loan.
22. ARM
    a. Adjustable Rate Mortgage. A common structure is known as 7/1. This means that the rate is fixed for 7 years, and then adjusts every year thereafter to prevailing market conditions. Generally also done on a 30 year amortization
23. Cap Rate
    a. This is the net return percentage (after all expenses) you would get if you paid a property in cash. This is the Net Operating Income (NOI) divided by Purchase Price. While used in residential real estate, avoid focusing on this in residential real estate as it is a bad metric in residential. Defined more in detail under commercial real estate.
24. Fed Funds Rate
    a. This is the interest rate at which banks lend money to each other overnight and is set by the Federal Reserve aka “The Fed”. When you hear about the Fed raising or cutting rates, this is the rate that is actually getting changed. This number is actually a range i.e. “4.25-4.5%”.
25. Prime Rate
    a. This is the interest rate that is used as a benchmark that commercial banks charge their best clients. It is 3% or 300 bps over the top range of the fed funds rate.
26. BPS

    a. Stands for Basis Points. 100 bps (pronounced bips) is equal to 1%, 50 bps is 0.5%, etc. The prime rate is 300 bps over the fed funds rate.

27. Septic/Well Utilities
    a. Septic is a sewage container dug into the ground. Well is an underground source of water that is tapped to provide water services to a house or house(s). Both of these are uncommon utilities in a city and a very common source of utilities in rural areas.
28. Historical Building
    a. A building in an area of town with a lot of history that is being preserved by the city. NEVER buy a house that is a historical building. Your costs will be outrageous to match the demands put on by the city.
29. Closing
    a. This is the name of the event when ownership is being transferred. "I'll meet you at the closing table" or "I need to go to closing"
30. Marketable Title
    a. Title (ownership) of the property is considered "free and marketable title" when it is free of any claims or disputes about who owns the property. All liens and mortgages must be paid at closing.
31. Escrow
    a. A third party that holds funds during a real estate transaction. Usually this is a title company or an attorney. The escrow/title agent ensures that no money or property changes hands until all the terms of the agreement or contract are satisfied.
32. Title (Escrow) State vs Attorney State
    a. States are divided where either a Title Company needs to direct the closing or where an attorney must. Some states are a Title State but require an attorney to review title or deed. Some states require an attorney to direct the closing. A quick google search can help you determine what kind of state you are in. The majority of states are Escrow or Title Company States.
33. Seller Financing
    a. When the seller agrees to finance you buying the property. This is generally only done when the property has some issue selling or the seller may choose this option to lower their tax burden so they get paid in installments rather than one large lump sum.
34. Quit Claim Deed
    a. A legal document that transfers interest in a property from one entity to another without any guarantees. Never do this.
35. Warranty Deed Transfer
    a. Unlike a quit claim deed, this is a legal document that transfers interest from one entity to another, while guaranteeing that the seller has clear title to the property and the legal right to sell it. The buyer is protected against any claims, as long as they have Title Insurance.
36. Title Insurance
    a. Title insurance is insurance that the escrow agent or title company offers the buyer. If there is ever a claim to the property, even though the property was bought with free and clear title, the insurance will settle any claims, rather than the buyer. It's a one time cost charged at closing for the protection of the buyer.
37. MLS/Zillow/On Market
    a. These are full retail listings. These are the most expensive properties as they generally do not have any way to add value to them. They're already in good shape 95% of the time
38. Pocket listings
    a. This is a realtor trying to sell a house WITHOUT going on the market. This is much like a wholesale deal, but it was given to the realtor to market because of an existing relationship.
39. Off-Market/Wholesaler Deals
    a. These are where the majority of my deals have historically come from. A wholesaler will market directly to a seller in distress (i.e. foreclosure, divorce, probate, etc) and get a property under contract. They will either do the deal themselves, or they will sell the contract for a profit to an investor like me. There are 3 parties: The seller, the wholesaler, and the end buyer. The seller agrees to sell the property to a wholesaler. The wholesaler sells or flips the contract to the end buyer and pockets the spread. The end buyer is the one that will own the house.
40. Direct to Seller
    a. Many of the best flippers and investors do this as they cut out the middleman (wholesaler). They will market to distressed sellers themselves and get properties at better prices due to doing the marketing themselves. The hard part of this is you're now adding a whole new business to an already existing business. Some people have the leadership and structure to do this, others don't.
41. Wholetail
    a. This is a property that was bought from either a wholesaler or direct from the seller and instead of doing the full flip, you do minor repairs and fixes, then the property is listed at a significant price increase, but still lower than market value. Many (especially out of state) investors don't have local contacts and can only search zillow for leads on houses. They are the ones who like to buy these properties. Generally, a clean out of trash would be done prior to listing. It is a mix of a wholesale deal and a retail deal.
42. Flip
    a. Probably the best known term here. Buy a house, fix it up, sell it. Hopefully make a profit. I can tell you from personal experience, much harder than they make it sound on TV!

<u>Hard Money Lending:</u>

1. Promissory Note
    a. This is a note made by a borrower to a lender that states the amount the borrower will pay the lender back.

2. Mortgage With Power of Sale
    a. This is a document that gets filed with the County Clerk that documents that a house has a mortgage and lender on it and allows the lender to foreclose on the property in event of default.
3. Personal Guaranty
    a. A document that allows the lender to force the sale or confiscate personal assets of the borrower, if the event the borrower does not fulfill its promise to pay back the lender.
4. Loan Points
    a. One point is one percent of a loan. 4 points of a $100,000 loan is $4,000. These are generally charged upfront at the property closing

Commercial Real Estate:

1. Class A
    a. The newest kind of property with modern amenities. This kind of property should be less than 10 years old
2. Class B
    a. This is a good condition property that used to be considered modern. Normally this kind of property will be 15 to 30 years old
3. Class C
    a. This is a fair condition property that is now outdated. Normally this kind of property will be 30 to 50 years old
4. Class D
    a. This is a bad condition property with lots of deferred maintenance. Normally this kind of property will be 30 to 100 years old and many times you can fear for your personal safety
5. Building Common Area
    a. An area of the building that can be used by all the tenants. Could be a lobby or shared bathrooms, but is not outside of the building, such as a parking lot.
6. Common Area Maintenance
    a. Often abbreviated CAM, this is the expenses in regards to maintaining shared areas of the building, such as landscaping, parking lot lights, and concrete walkways outside of stores. This is generally charged back to the tenants of the building
7. Gross Leasable Area
    a. GLA is total floor area just for a single tenant's use
8. Parking Index
    a. A number, generally recommended from 4 to 5, that will tell you the amount of parking spots per every 1000 sq ft of GLA
9. VPD/CPD
    a. Vehicles Per Day/Cars Per Day. This tells you traffic count and how many cars are going on a specific road per day
10. Absorption
    a. The amount of space that has been leased in a year. Generally will be class specific. For example, the absorption rate of industrial warehouses was 1.2 million square feet last year in Oklahoma City
11. Cap Rate
    a. This is the net return percentage (after all expenses) you would get if you paid a property in cash. The formula is NOI / Property Price = Cap Rate. For example, if a property is being offered for $1,000,000 and after all expenses (management, taxes, repairs and maintenance, insurance, vacancy etc), the NOI is $50,000 the cap rate of this property is $50,000 / $1,000,000 = 5%. This is called a 5 cap
12. GOI
    a. Gross Operating Income. This is the total amount of income a property brings in yearly
13. TOE
    a. Total Operating Expenses. This is the total amount of expenses a property has yearly, not including debt payments.
14. NOI
    a. This is the net income after all operating expenses, not including debt payments. The formula is GOI - TOE = NOI
15. DSCR
    a. Debt Service Coverage Ratio. Can also be called DCR or DSR. This is your NOI / Annual Debt Service. For example if your NOI is $120,000, and your Annual Debt Service is $100,000, your DSCR is $120,000 / $100,000 which equals 1.2
16. Global DSCR
    a. Generally DSCR is done for one property. A global DSCR is your DSCR for all your properties or even sometimes including your income from your primary job.
17. Depreciation
    a. Depreciation is a way of writing the inferred loss of value of a structure over time against your income. This will be gone over in depth in Chapter 9
18. 1031 Exchange
    a. A tax deferral strategy that allows you to sell one investment property and reinvest the proceeds into another real estate investment, without paying capital gains taxes or recapturing depreciation. Up to 3 replacement properties have to be identified within 45 days and purchased within 180 days.
19. Easements
    a. The right of one party to use another party's property for a specific purpose
    b. Most common easement is utility lines running across a parcel of land

    c. Survives indefinitely unless the beneficiary removes it

20. Covenants
    a. This is promise between property owners to do something land related
21. Appraisal
    a. This is a 3rd party report that is an opinion of the value of a certain real estate. Banks generally require this and will lend on the lower of a percentage of the contract price or appraisal value
22. Boundary Survey
    a. This is a map that accurately determines the location of a property lines and the monuments that mark the property corners of a parcel of land as described in a deed
23. Deed
    a. This is a legal document that records the sale or transfer of real estate and states who is the owner
24. Certificate of Occupancy
    a. A legal document that shows that a property is completely up to local codes and ordinances and is fit for use or inhabitation
25. Phase 1 Environmental
    a. This is a report that checks to see if there are any environmental concerns from current commercial usage or past commercial usage. Gas stations, laundromats, and oil change locations generally can have issues come up on environmental concerns
    b. If a Phase 1 comes up “dirty”, a phase 2 is needed. If Phase 2 is dirty, then phase 3 is needed. Generally if a phase 1 is dirty, and a phase 2 is dirty, then the deal will die until remediation efforts have been made and proven effective
26. Title Commitment/Report
    a. This is a document that describes the rights being transferred during a property transaction, as well as any exceptions that won’t be covered
27. Recourse Loan
    a. A loan which is not only guaranteed by the entity that is borrowing money and the property, but also the personal assets of the guarantors
28. Guarantor
    a. An individual who is guaranteeing the loan repayment by putting up all their personal assets as collateral in addition to the property being loaned on
29. Non-Recourse Loan
    a. A loan which is only guaranteed by the entity that is borrowing money and the property itself. There are no guarantors on this loan
30. Lien Search
    a. This is an investigation into the property to see if there is anyone that has a financial claim via liens or encumbrances on the property. Done by the title company or attorney
31. Zoning
    a. The set of rules that govern how land may be used and the development standards for all property within a county
32. PPF
    a. Price Per Foot. This is the price / total rentable square feet. For example, if a property is being sold at $3,000,000 and the total rentable square feet is 15,000 sq ft, then the price per foot is $200 per foot
33. Replacement Cost
    a. This is the cost per foot to rebuild a property to the exact same dimensions. You will hear brokers say “well below replacement cost” when they are trying to say a property is a good value
34. Net Leases
    a. This is a lease where some or all of the expenses with the property are being billed back to the tenant. Sometimes a net lease is referred to as a true triple net (NNN) lease and sometimes it is a lesser lease
35. Absolute NNN Lease
    a. This is when every expense related to the property (all repairs, maintenance, insurance, and taxes) are being paid by the tenant
36. NNN Lease
    a. This is when a tenant pays a base rent plus CAM, property tax, and property insurance
37. NN Lease
    a. This is when a tenant pays a base rent plus property tax and property insurance
38. N Lease
    a. Also known as single net lease. This is when a tenant pays a base rent plus property tax
39. Modified Gross Lease
    a. This is a lease that has a base rent plus some modification (IE tenant to pay for first $1500 in HVAC repairs)
40. Gross Lease
    a. This is a lease where all a tenant pays is a base rent amount. All expenses related to the property are paid by the landlord. In the commercial world, this is called a gross lease. In the residential world, this is the standard type of lease.
41. Tenant Improvement
    a. Tenant Improvement. This is what a landlord will pay to allow a tenant to update or renovate the space they are moving into. Generally, this will be billed back to the tenant over the term of their lease by having a higher base rent
42. Leasing Commissions
    a. Paid to the listing broker and the broker representing the tenant. I negotiate to pay 2% when signed, 2% when occupied, 2% when rent concession has ended

43. Incentives/Concessions
    a. This is any concession a landlord may give to a tenant leasing the space. Very common incentive is waived rent for the first 3 months while the business sets itself up
44. SNDA
    a. Subordination, Non-Disturbance and Attornment Agreement. This short form has multiple purposes. It protects the tenant and the lender.
    b. Subordination: This means that the tenant’s interest in the property (lease of the space) is lower priority than the lender’s interest in the property. The lender takes preference. Most leases will say that a tenant must sign an SNDA form upon request. This make it easier for the landlord to get a loan and the lender to feel comfortable making the loan
    c. Non-Disturbance: This protects the tenant. In the event of a landlord getting foreclosed on, the tenant will be able to continue to use the leased premises until the end of the base term.
    d. Attornment Agreement: This means that if the landlord gets foreclosed on, the tenant will agree to make payments to the lender as the new landlord or whoever the property may get transferred to
45. Estoppel
    a. This is a document that summarizes a tenant's lease agreement with a landlord and establishes the current status of the lease.
46. PCA
    a. Property Condition Assessment. This is the name for an inspection in the commercial world. Inspection is the name in the residential world.
47. Commitment Letter
    a. This is a letter that is given to a borrower outlining the terms of the loan that the bank has approved. This is much stronger than a pre-approval and a strong certainty that the bank will be able to lend to the borrower.
48. Dark Building
    a. Tenant left, but is still paying rent until the end of the lease
49. LOI
    a. Letter of Intent. Non-binding contract stating what terms you want to buy a property at
50. PSA
    a. Purchase and Sale Agreement. The official contract that you will be using to buy the building outlining in detail the terms of the sale