

Real Estate Finance & Investment

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REA 631

Lecture (3)
Statement of cash flows in
property industry





Learning Outcomes

1

Net income vs. net cash flow

Explain why an accrual profit differs from the cash a business actually generates.

2

Usefulness of the statement

Show what the cash flow statement reveals that the income statement cannot.

3

Three activity classes

Distinguish operating, investing and financing cash flows — with property examples.

4

Prepare it (indirect method)

Build the operating section by reconciling from net income.

5

Compute free cash flow

Measure the cash left over for growth, debt and investors.



Net Income Is Not Net Cash



Income Statement

ACCRUAL BASIS

100,000,000

Records revenue when earned and expenses when incurred
— regardless of cash.



Cash Flow Statement

CASH BASIS

50,000,000

Records only cash actually received and paid during the
period.



The gap is real. A company can report a large accounting profit yet hold far less cash — because sales on credit, inventory and receivables tie cash up. The cash flow statement explains that difference.



Profitable on Paper, Short on Cash

Real estate is a cash-intensive, long-cycle business. A developer can be highly profitable yet face a liquidity squeeze — which is exactly why lenders and investors read the cash flow statement first.



2–4 yrs

Typical cash gap between buying land and selling finished units



70–80%

Share of project cost often funded by debt — heavy financing flows



Off-plan

Pre-sales bring cash in early, before profit is recognised

Bottom line: *profit answers “did the project make money?” — cash flow answers “can we pay the contractor next month?” Both questions decide whether a development survives.*



Usefulness of the Statement



Future cash-generating ability

Assess whether the entity can keep producing cash from its core operations.

01



Ability to pay dividends & debts

Judge capacity to meet obligations — loan instalments, suppliers and investor returns.

02



Why profit ≠ cash

Reveal the reasons net income differs from net cash from operating activities.

03



Three Classes of Cash Flow



OPERATING

Day-to-day business

Income-statement items & short-term
(current) balance-sheet accounts

*Rent collected · supplier payments ·
salaries*



INVESTING

Building the asset base

Long-term assets & investments — the
property portfolio itself

Buy / sell land · construction · loans made



FINANCING

Funding the business

Long-term liabilities & equity — how
the firm is capitalised

Mortgages · share issues · dividends paid



Operating Activities

The engine room

Cash effects of the transactions that determine net income.

Linked to:

- Income-statement items (revenues & expenses)
- Current assets — A/R, notes receivable, inventory, prepaids
- Current liabilities — A/P, notes payable, accruals, unearned revenue



In a real estate firm



Rent & service charges collected from tenants



Cash paid for maintenance, utilities, staff



Property-management & brokerage fees received



Interest paid on operating financing



Changes in receivables from buyers / tenants



Investing Activities

Building the asset base

Purchase and sale of long-term assets and investments.

Keywords:

- Purchase / sale of fixed assets (PPE)
- Purchase / sale of investments & securities
- Loans made to — and collected from — others



CASH INFLOWS

- Sale of property, plant & equipment
- Sale of investments
- Collection of loan principal



CASH OUTFLOWS

- Purchase of PPE — land, buildings, equipment
- Purchase of investments / equity securities
- Loans made to other entities



Financing Activities

Funding the business

Cash from owners and lenders — and what is returned to them.

Keywords:

- Issuance of shares / borrowing
- Repayment of long-term debt
- Payment of dividends to owners

↑ CASH INFLOWS

- Issuing (selling) common stock
- Issuing long-term debt — bonds & notes
- Selling treasury stock

↓ CASH OUTFLOWS

- Paying dividends to stockholders
- Redeeming (repaying) long-term debt
- Reacquiring treasury stock



Classifying Real-Estate Cash Flows

Rent collected from tenants

OPERATING

Buying land / a building to hold as an investment

INVESTING

Construction & development capital expenditure

INVESTING

Proceeds from a mortgage taken to acquire property

FINANCING

Repaying mortgage principal

FINANCING

Dividends paid to property-fund investors

FINANCING

Sale of an investment property

INVESTING



Developer vs. investor

A crucial nuance:

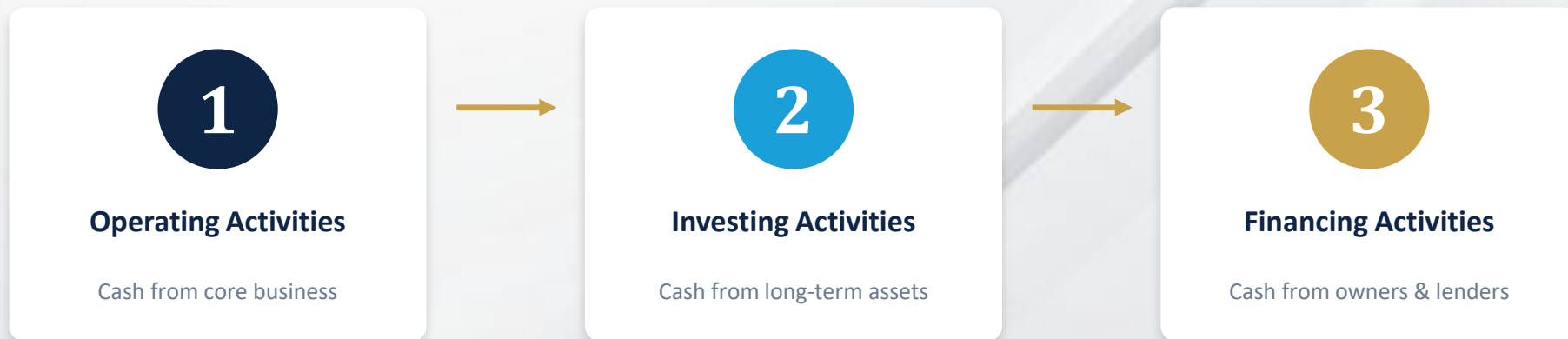
If a firm builds units to sell, those units are inventory. Cash from selling them is OPERATING, and construction costs run through working capital — not investing.

If a firm holds property to earn rent, buying and selling it is INVESTING, while the rent is OPERATING.



Format & Order of Presentation

The statement always reports the three sections in the same order, then reconciles to the change in cash.



+ Net change in cash = Operating + Investing + Financing, then add the beginning cash balance to confirm the ending balance.



Direct vs. Indirect Method

INDIRECT METHOD

Starts from net income and adjusts for non-cash items and changes in working capital to reach net operating cash.

DIRECT METHOD

Lists actual cash receipts and payments — cash from customers, cash to suppliers — line by line.



Why Companies Favour the Indirect Method



01

Easier & cheaper to prepare

It works straight from the income statement and comparative balance sheets — no need to re-track every cash receipt and payment.



02

Explains the profit–cash gap

It puts net income and net operating cash side by side, showing exactly which items caused them to diverge.

This course prepares the operating section using the indirect method.



Operating Section — The Blueprint

Net income

× ×

Adjustments to reconcile to net cash:

Depreciation & amortization

+

Loss on sale of fixed assets

+

Gain on sale of fixed assets

(×)

Increase in current assets (A/R, inventory)

(×)

Decrease in current assets

+

Increase in current liabilities (A/P, N/P)

+

Decrease in current liabilities

(×)

Net cash provided by operating activities

× ×

Read it like this



ADD back: non-cash expenses, losses, sources of cash



DEDUCT: gains and uses of cash



Property tie-in

Building depreciation is large and non-cash — it is always added back here.



Reading the Signs

CURRENT ASSETS

- Accounts receivable
- Notes receivable
- Inventory
- Prepaid expenses

INVERSE relationship

Asset $\uparrow$ $\rightarrow$ cash $\downarrow$ · Asset $\downarrow$ $\rightarrow$ cash $\uparrow$

CURRENT LIABILITIES

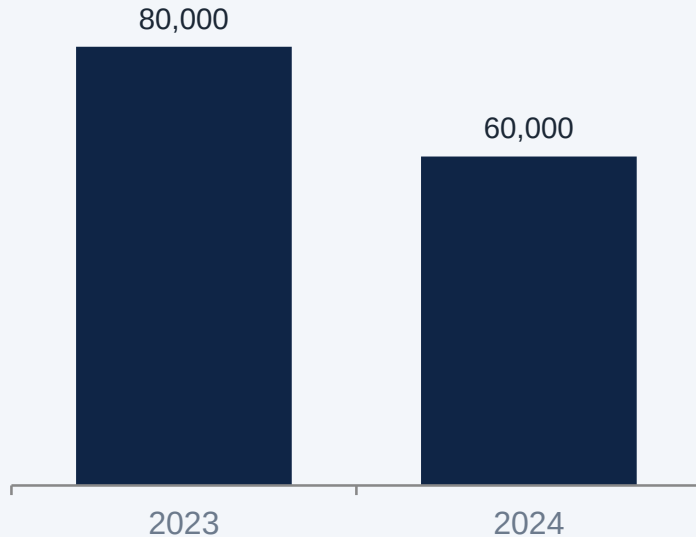
- Accounts payable
- Notes payable
- Accrued / expense payable
- Unearned revenue

DIRECT relationship

Liability $\uparrow$ $\rightarrow$ cash $\uparrow$ · Liability $\downarrow$ $\rightarrow$ cash $\downarrow$



When Inventory Falls, Cash Rises



Inventory ↓ \$20,000

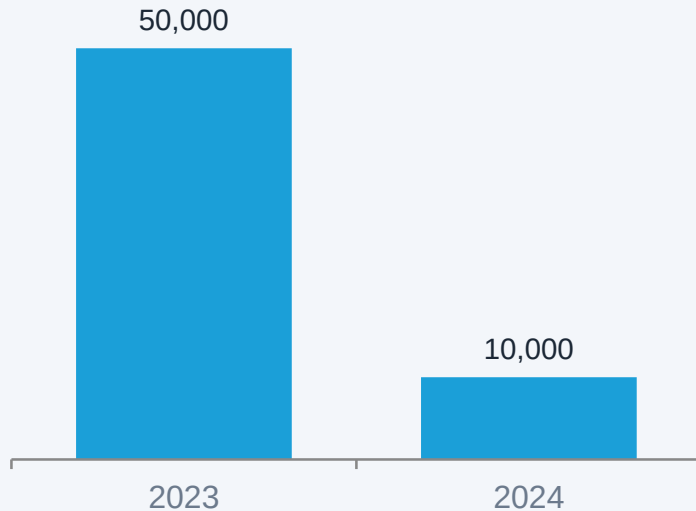
Reflects an increase of +\$20,000 in cash

Why?

Selling inventory converts it into cash. The asset shrank because goods were sold — so the \$20,000 decrease is ADDED back to net income in the operating section.



When Payables Fall, Cash Falls



Accounts payable ↓ \$40,000

Reflects a decrease of **−\$40,000** in cash

Why?

A liability falls only when it is paid off. Settling \$40,000 of payables used cash — so the decrease is DEDUCTED from net income in the operating section.



Adjustments at a Glance

NON-CASH CHARGES

Depreciation expense

Add

Amortization expense

Add

Depletion expense

Add

GAINS & LOSSES

Loss on sale of asset

Add

Gain on sale of asset

Deduct

CURRENT ASSETS / LIABILITIES

Increase in current asset

Deduct

Decrease in current asset

Add

Increase in current liability

Add

Decrease in current liability

Deduct



Reconciling to \$45,000

Example

- Net income \$50,000
- Accounts receivable increased by \$7,000
- Accounts payable decreased by \$3,000
- Depreciation expense \$5,000

Q: Net cash from operating activities?

Operating section

(A)

Net income	50,000
Increase in accounts receivable	(7,000)
Decrease in accounts payable	(3,000)
Depreciation expense	5,000

Net cash provided by operations	45,000
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A Fuller Reconciliation → \$152,000

Example

- Net income \$180,000
- Depreciation \$26,000
- A/R increased by \$15,000
- Inventory increased by \$40,000
- Prepaid exp. Decreased by \$2,000
- A/P decreased by \$4,000
- Loss on sale of equip. \$3,000

Net income	180,000
Depreciation expense	26,000
Increase in accounts receivable	(15,000)
Increase in inventory	(40,000)
Decrease in prepaid expenses	2,000
Decrease in accounts payable	(4,000)
Loss on sale of equipment	3,000

Net cash from operating activities	152,000
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Investing Activities — The Cash Map



Rule of thumb: if a long-term asset or investment was bought or sold, the cash belongs here. Spending cash on assets is an outflow; receiving cash from them is an inflow.



INFLOWS (+)

- Proceeds from selling PPE / property
- Proceeds from selling investments
- Collecting principal on loans made



OUTFLOWS (-)

- Buying PPE — land, buildings, equipment
- Buying investments / securities
- Making new loans to others



Investing Section → (\$103,000)

Given

- Purchases of PPE \$120,000
- Proceeds from sale of PPE \$92,000
- Purchase of investments \$45,000
- Collection of loans \$5,000
- New loans made \$35,000

Note: depreciation & gains are non-cash here — they belong to the operating section, not investing.

Purchases of PPE (120,000)

Proceeds from sale of PPE 92,000

Purchase of investments (45,000)

Collection of loans 5,000

New loans made to others (35,000)

Net cash used by investing activities (103,000)



Real-Estate Investing in Action

For a property company, the investing section is usually the largest and most negative during growth — it captures the cash poured into acquiring and building the portfolio.



Land acquisition

OUTFLOW



**Construction /
development capex**

OUTFLOW



**Buying an income-
producing building**

OUTFLOW



**Selling a completed
investment property**

INFLOW



**Disposing of equipment or
fit-out**

INFLOW



**Collecting on a loan to a
joint venture**

INFLOW



Financing Activities — The Cash Map



Rule of thumb: financing answers “where did the capital come from, and what went back to investors and lenders?” — long-term debt and equity, plus dividends.

↑ INFLOWS (+)

- Issuing shares (common stock)
- Issuing long-term debt — bonds, mortgages
- Selling treasury stock

↓ OUTFLOWS (–)

- Paying dividends to stockholders
- Repaying long-term debt / mortgage principal
- Buying back treasury stock



Comprehensive Example : Step 1 — Operating → \$79,000

Data provided

- Net income 40,000
- Depreciation 18,000
- Loss on sale of land 10,000
- A/P ↑ 13,000
- A/R ↑ 7,000
- Inventories ↓ 5,000
- Issue share capital 20,000
- Dividends paid 1,000
- Collect LT notes 5,000
- Acquire equipment 40,000
- Pay LT debt 13,000
- Sell land 32,000

Operating activities (indirect)

Net income	40,000
Depreciation expense	18,000
Loss on sale of land	10,000
Increase in accounts payable	13,000
Increase in accounts receivable	(7,000)
Decrease in inventories	5,000

Net cash from operating activities	79,000
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Step 2 — Investing & Financing

Investing activities

Collection of LT notes receivable	5,000
Acquisition of equipment	(40,000)
Proceeds from sale of land	32,000

Net cash — investing	(3,000)
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Financing activities

Issuance of share capital	20,000
Payment of dividends	(1,000)
Payment of long-term debt	(13,000)

Net cash — financing	6,000
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Significant Non-Cash Activities

Important transactions that change assets, debt or equity without moving cash. They never appear in the three sections — they are disclosed separately.



Issue stock to acquire assets

Shares given directly for property or equipment



Convert bonds into common stock

Debt becomes equity — no cash changes hands



Issue debt to purchase assets

A note payable swapped for equipment or land



Exchange of plant assets

One asset traded directly for another



Free Cash Flow

Cash from
Operations

—

Capital
Expenditures

—

Cash
Dividends

=

Free Cash
Flow

Free cash flow is the cash left from operations after maintaining the asset base and rewarding owners — the cash truly available for growth, debt reduction or new acquisitions.



In real estate: heavy development capex can push FCF negative for years even on a profitable project — which is normal in a growth phase, but lenders watch the trend closely.



Quiz · Questions 1–2

Q1

All of the following are presented on the statement of cash flows EXCEPT:

MULTIPLE CHOICE

A Financing activities

B Operating activities

C Investing activities

D Advertising activities

Q2

Activities that create long-term liabilities are usually:

MULTIPLE CHOICE

A Investing activities

B Financing activities

C Advertising activities

D Operating activities



Quiz · Questions 3–4

Q3

Activities impacting long-term assets are:

MULTIPLE CHOICE

A Investing activities

B Financing activities

C Marketing activities

D Operating activities

Q4

Issuing bonds payable is reported under:

MULTIPLE CHOICE

A Investing activities

B Operating activities

C Financing activities

D Non-cash activity



Quiz · Questions 5–6

Q5

Selling equipment is reported under:

MULTIPLE CHOICE

A Operating activities

B Investing activities

C Financing activities

D Non-cash activities

Q6

Under the indirect method, an increase in prepaid insurance should be:

MULTIPLE CHOICE

A Added to current assets

B Added to net income

C Included in payments

D Subtracted from net income



Quiz · Questions 7–8

Q7

Paying cash dividends is classified as:

MULTIPLE CHOICE

A Operating activities

B Investing activities

C Financing activities

D Non-cash activity

Q8

Under the indirect method, a gain on the sale of PPE would be:

MULTIPLE CHOICE

A Reported in investing section

B Ignored — no cash effect

C Deducted from net income

D Added to net income



Quiz · Questions 9–10

Q9

Under the indirect method, an increase in accounts payable should be:

MULTIPLE CHOICE

A

Added to net income

B

Deducted from net income

C

Reported in investing

D

Reported in financing

Q10

Which is an example of a cash flow from an investing activity?

MULTIPLE CHOICE

A

Issuance of bonds payable

B

Repurchase of capital stock

C

Sale of equipment

D

Payment to suppliers



Quiz · Questions 11–12

Q11

A developer's purchase of land for future development is classified as:

MULTIPLE CHOICE

☐ A Operating activities

☒ B Investing activities

☐ C Financing activities

☐ D Non-cash activity

Q12

Rental income collected from tenants on an investment property is:

MULTIPLE CHOICE

☒ A Operating activities

☐ B Investing activities

☐ C Financing activities

☐ D Non-cash activity



Quiz · Questions 13–14

Q13

Proceeds from a mortgage taken to acquire a property are classified as:

MULTIPLE CHOICE

A Operating activities

B Investing activities

C Financing activities

D Non-cash activity

Q14

Under the indirect method, depreciation on a building is:

MULTIPLE CHOICE

A Deducted from net income

B Added to net income

C Ignored entirely

D Reported in investing



Quiz · Questions 15–16

Q15

Under the indirect method, a decrease in inventory is:

MULTIPLE CHOICE

A

Added to net income

B

Deducted from net income

C

Reported in financing

D

Ignored

Q16

The indirect method is used by the vast majority of companies ($\approx 98.8\%$).

TRUE / FALSE

✓

True

False



Quiz · Questions 17–18

Q17

Net income and net cash flow from operations are always equal.

TRUE / FALSE

True

✓ False

Q18

A gain on the sale of property is deducted in the operating section to avoid double-counting the cash, which appears under investing.

TRUE / FALSE

✓ True

False



Quiz · Questions 19–20

Q19

Issuing common stock directly to purchase a building is a cash inflow in financing activities.

TRUE / FALSE

True

✓ False

Q20

Free Cash Flow = Operating cash – Capital expenditures – Cash dividends.

TRUE / FALSE

✓ True

False

Thank You