# Cash-flow or ROI—Which is More Important?

*A Pinnacle Perspective*

By: Mike D'Arrigo
Pinnacle Investment Properties, LLC

At first glance this question doesn't seem to make a lot of sense you might say. After all, doesn't high cash flow mean a high ROI? Not necessarily. Why? ROI is a function of acquisition cost whereas cash flow is strictly a function of income and expenses. Too often, investors get hung up on CAP rates and cash on cash returns and lose sight of what really counts---how much cold, hard cash they're taking to the bank.

New investors often have some ROI figure in their head—however arbitrary it might be—but are much less clear on their cash-flow objective. I frequently hear investors say something like "I want a minimum of a 10% CAP rate" however, I rarely hear them say "I want a minimum of $300 per month cash flow and I want the property to pay for itself in 10 years or less".

ROI is a basic tool that investors use when evaluating and comparing competing investment options. It's a useful metric to measure an investment's gains against its cost, however it doesn't give the full picture. After all, often times, the property with the highest ROI is the one with the lowest cash flow as the three scenarios below show. So which is the better investment?

| | **Scenario A** | **Scenario B** | **Scenario C** |
|---|---|---|---|
| Purchase Price | $80,000 | $70,000 | $55,000 |
| Monthly rent | $1000 | $850 | $750 |
| Net Operating Income | $7100 | $6500 | $5600 |
| CAP Rate | 8.9% | 9.3% | 10.2% |

If you made your decision based on CAP rates alone, Scenario C would be the best investment, however, your cash flow under Scenario A would be $600 per year more than Scenario B and $1500 per year more than Scenario C.

Investors are commonly confronted with this dilemma when evaluating different classes of properties with varying acquisition costs. For instance, it's quite common for a B class property to have higher cash flow and a lower ROI than a C class property due to its higher acquisition cost as in the scenarios above.

To decide which is the best option for you, you'll need to start by clearly defining your investment goals and answering these questions:

1. Is your primary goal cash flow or appreciation?
2. How much capital do you have to work with?
3. Are you financing or paying cash?
4. If financing, when do you want to have it paid off?
5. How much cash flow do you want?
6. Do you need cash flow now or in the future?

## Know What You Want

If appreciation is your goal, you might have to settle for a lower ROI. Some of the "hot, glamorous " markets that are currently seeing rapidly escalating prices are also seeing return on investment from cash flow being driven down. It's important to know where your yield is projected to come from. So when evaluating properties, you'll want to see a pro forma projection of the expected yield from both cash flow and from appreciation. If the appreciation isn't expected to come for several years as in some markets, you'll want to evaluate the Net Present Value (NPV) of that future equity gain against alternatives providing immediate cash flow. Net present value is a financial principal that says receiving $1.00 in a year from now is not the same as receiving $1.00 today. Many times, the net present value of future appreciation doesn't stack up so well against a high cash flow property with little or no appreciation.

Let's take a look at two hypothetical scenarios. John is considering two very different investment opportunities. One option offers strong appreciation potential with break-even cash flow while the other offers good cash flow but no appreciation. He wants appreciation, and because he didn't learn his lesson from the 2007 market crash, he's willing to accept a break-even cash flow, or even a small negative, counting on values to go up in 5 years.

| | Option 1 | Option 2 |
|---|---|---|
| Purchase price: | $100,000 | $60,000 |
| 5 year cash flow | $0 | $15,610 |
| 5 year appreciation | $24,890 | $0 |
| **Total 5 year return** | **$24,890** | **$15,610** |

At first glance this looks like a no brainer. After all, Option 1 clearly produces more of a return than Option 2. However, to fully understand the returns from both options, we need to look at the future value of the returns over the 5 year period. $1 in 5 years from now is worth only $.86 today assuming 3% inflation. So, to determine which is the better investment, we need to look at the net present value of the income stream of both options. Fortunately, there are some cool calculators that will do that for us.

In the table below, you'll see that the returns are distributed over the 5 year period much differently. Most of the appreciation from Option 1 won't be realized until years 4 and 5, whereas the cash flow from Option 2 is fairly constant over the same period. This time value must be considered.

| | Investment | Yr 1 | Yr 2 | Yr 3 | Yr 4 | Yr 5 | Total | NPV |
|---|---|---|---|---|---|---|---|---|
| **Property A Appreciation** | $20,000 | $1,000 | $2,020 | $3,090 | $7,430 | $11,350 | $24,890 | $2,097 |
| **Property B Cash Flow** | $12,000 | $3,000 | $3,060 | $3,120 | $3,180 | $3,250 | $15,610 | $2,280 |

When you evaluate the net present value of both investments, you'll see a much different picture. Although Option 1 provides the greatest returns in 5 years, you clearly see that Option 2 has the better present value of $2,280 compared with $2,097 for Option 1. When factoring in time value, future appreciation potential isn't always as appealing as it might appear.

## How Much Do You Have to Invest?

The answer to this question will often decide whether you buy a property with high cash flow or high ROI. If you have limited capital, you'll be constrained in the type of property you buy. It may be that you can only afford a lower priced property which typically has lower rent and cash flow but higher ROI due to the low acquisition cost.

## Financing or Cash?

How you buy will determine your cash flow. By paying cash your cash flow will be much higher than if you finance because you won't have debt service, but your capital will then be tied up, limiting your ability to grow your portfolio. By using leverage, you can have the best of both worlds. Instead of CAP rates of 8-10%, you can have cash-on-cash returns of 20%-25%. Because you'll be stretching your purchasing power, you'll be able to buy better properties with higher rents, thereby giving you higher cash flow.

## How Soon Do You Want to Own It?

If you are financing, you'll want to have a goal for how long it will take to pay off the mortgage. Investors frequently finance with a 30 year mortgage and then give little thought to paying it off sooner. If you're 30 years old and won't need the cash flow for many years, that might be ok if you don't mind paying the bank all that interest. If you're 50 years old and are counting on the cash flow for your retirement, you might want to think about how to pay it off a lot sooner. As part of your overall investment plan, you need to figure out how soon you want to own you investments free and clear and evaluate whether a property will pay for itself through cash-flow within your desired timeframe.

## How Much Cash flow Do You Need?

Determining how much cash flow you need is one of the first things you need to do. This will drive your entire investment strategy. It's one thing if you want a little extra cash flow to pay for nice vacations and those toys you can't live without and something entirely different if you want to replace your income and quit your job in 5 years. Knowing how much income you need to generate will determine the size of the portfolio you need to acquire and the types of properties you buy. If your goal is to have $5000 per month of passive income and the average property produces $500 per month in cash flow with no debt service, you know you need a portfolio of 10 properties to produce the income you want.

## When Do You Need the Cash?

Timing of your cash flow needs is a factor that must be considered. A 30 year old investor just starting out has much different cash flow needs than a 55 year old investor nearing retirement age. In the early years, building a portfolio is generally your first priority and cash flow secondary. For the investor needing to replace their income after retirement, maximizing cash flow income becomes the primary goal. Assets in typical retirement accounts generally do not generate enough income without having to draw on principal, therefore, converting assets to income is most important in the retirement years. Self directed IRA's allow the purchase of real estate and can be an excellent way to fund a real estate portfolio that will produce a high income stream to fund your retirement without drawing down your principal.

Personally, I subscribe to the old adage that says you take dollars to the bank, not percentages so I'm more interested in cash flow than ROI. That's not to say that I don't think ROI is important however. ROI is just one of the metrics that you should consider when doing due diligence on an investment property. If you're looking at several investments that all meet your minimum ROI objective, the one that produces the most cash flow regardless of ROI is the best choice in my opinion. What do you think and what's most important to you when comparing investments with different returns?

*Mike D'Arrigo is owner of Pinnacle Investment Properties, LLC, a provider of turn-key, cash-flow residential properties in high yield markets. Contact Mike at (408) 661-5903 or* ***m.darrigo@sbcglobal.net***