

How To Analyze a Cash-flow Property ---What The Numbers Mean.

A Pinnacle Perspective

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There's a lot of factors to consider when evaluating the profit potential of an investment property but any evaluation starts with crunching the numbers. Don't worry, you don't have to be a financial whiz to understand the numbers but a basic grasp of some financial concepts and terminology are crucial.

Your analysis will include a review of all the projected income and expenses expressed in the form of key ratios.

Understanding the significance of the ratios is the key to making smart investment decisions. These ratios will be based on certain assumptions that you must make about income and expenses. It's important to be as conservative as possible with your assumptions. Many investors get emotionally attached to a potential deal and change their assumptions to "make the numbers work". Don't make this mistake. If the deal doesn't work on paper, it surely won't work in reality.

Following are the basic terms and definitions that you'll want to master and understand when evaluating the investment potential of any cash-flow property.

Financial Reports

The most common form of presenting income and expenses are the Pro forma Cash Flow Projection and the Profit and Loss Statement.

Pro Forma

A method of calculating financial results in order to emphasize either current or projected figures. The pro forma may be used to project the expected future financial performance of an investment and is an estimate only.



Profit & Loss Statement (P&L)

A financial statement that summarizes the actual revenues, costs and expenses incurred during a specific period of time - usually a fiscal quarter or year. The P&L is an accounting statement of past financial performance.

Income and Expenses

Gross Income

This is the total potential income before any loss of rent or operating expenses.

Net Income = (Gross Income – Vacancy)

Any cash-flow projection should include an assumption for vacancy. This is the income after vacancy and before any operating costs. The vacancy factor should be based on the current vacancy rates for the market and neighborhood.

Operating Expenses

Operating Expenses are all expenses related to the operation of the business. These expenses include property taxes, insurance, maintenance and property management. Utilities should be included if the landlord is responsible for these expenses. True costs should be used for taxes, insurance and management. Maintenance must be estimated.

Net Operating Income = (Gross Income – Operating Expenses)

Net Operating Income is the sum of all income after vacancy and operating costs. This is the income from the direct operation of the business.

Debt Service

If the property has a mortgage, this is the minimum monthly mortgage payment

Cash-flow = (Net Operating Income – Debt Service)

Cash-flow is what is left after all operating expenses and mortgage payment.

Principal Reduction

If there is a mortgage on the property, a portion of the monthly mortgage payment will be applied to principal thereby increasing the equity in the property.

Appreciation

Appreciation is the increase in value due to a rise in prices

Gross Equity Income

Gross Equity Income is the increase in equity due to a combination of principal reduction and appreciation.

Financial Indicators

Return on Investment (ROI)

There are two commonly used methods of measuring return on investment in real estate which are often confused and used interchangeably. It's important to understand the difference between the two.

1. Capitalization Rate or CAP Rate = (Net Operating Income / Acquisition Cost)

The CAP Rate is a simple ratio between the net operating income and the acquisition price of the property. It does not consider financing and is therefore more applicable to a cash purchase.

2. Cash-on-Cash Return = (Net Operating Income/Capital Investment)

The Cash-on Cash Return measurement takes financing in to consideration. It is a ratio between the net operating income and the capital invested. Invested capital consists of the down payment, escrow/closing costs and financing fees.

Gross Rent Multiplier = (Purchase Price/Gross Rent)

The Gross Rent Multiplier is used to establish the value of a cash-flow property and compare it with similar properties. It is the ratio of the price of the property to its annual gross rent before vacancy and expenses. The lower the Gross Rent Multiplier, the better the deal.

Rent to Price Ratio = (Monthly Gross Rent/Purchase Price)

This is the inverse of the Gross Rent Multiplier. It is the rent as a percentage of the price. The higher the Rent to Price Ratio, the better.

Debt Coverage Ratio = (Debt Service/Net Operating Income)

This is the ratio between the net operating income and the debt service and measures the ability to cover the mortgage payment through cash-flow. The higher the ratio, the better the ability to pay for the debt service through the cash-flow.

Payback Period

This is a measurement of the length of time it takes to pay off the mortgage through cash-flow

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