

Silver Success Club's Secrets to:

FINANCIAL ANALYSIS

Capitalization Rate—is often used to determine the value of income producing investments.

The following formulas are used with for Capitalization Rate.

Cap Rate = NOI divided by Property Value

EXAMPLE:

\$15,600 (NOI) divided by \$150,000 (Property Value) = 10.4% Cap Rate

NOI = Property Value multiplied by Cap Rate

EXAMPLE:

\$150,000 (Property Value) multiplied by 10.4% (Cap Rate) = \$15,600 (NOI)

Property Value = NOI divided Cap Rate

EXAMPLE:

\$15,600 (NOI) divided by 10.4% (Cap Rate) = \$150,000 (Property Value)

Cap rate calculation is highly subjective. Therefore investors must be certain to use realistic figures. The amount used for the total amount invested should include both the down payment and the borrowed money necessary to make the purchase.

So if Cap Rates went to 9.4% from 10.4% a year or so ago. Take the (NOI) \$15,600 and divide it by the (Cap Rate) 9.4%. It would increase the value to \$165,957.

Or

So if Cap Rates went to 11.4% from 10.4% a year or so ago. Take the (NOI) \$15,600 and divide it by the (Cape Rate) 11.4%. I would lower the value to \$136,842.

Net Operating Income (NOI), is gross income, minus all operating expenses with the exception of debt service.

EXAMPLE:

Rents are \$1,650 a month, which produces \$19,800 annual gross, less \$3,000 taxes and insurance, \$1,200 for maintenance and repair. You have an NOI of \$15,600.

Cash on Cash Rate of Return—uses cash flow analysis to determine the value of property.

It is calculated using the following formula:

Net Operating Income less Debt Service divided by Equity.

EXAMPLE: A property's Net Operating Income is \$15,600, with a Debt Service of \$10,560, giving a Cash Return of \$5,040.

The owner's Equity is \$30,000.

Cash on Cash rate of return = \$5,040 divided by \$30,000 = 0.168 or 16.8%

Comparative Market Analyses (CMA)—a real estate appraisal term for determining what price the property is likely to bring in the local market at a certain point in time. The value is determined by comparing the subject property to similar properties that have recently sold, those that did not sell, and those that are currently being offered for sale. The best indicator of value for owner occupied housing.

Debt Coverage Ratio (DCR)—is the ratio between the annual Net Operating Income and the Annual Debt Service.

The formula would be NOI divided by Annual Debt Service.

EXAMPLE:

(NOI) \$15,600 divided by \$10,560 (Annual Debt Service) = 1.477 (DCR)

The investment property generates almost 50% more net income than it needs to make its mortgage payments.

Most lenders require a Debt Coverage Ratio of at least 1.2 and usually desire 1.5 to finance an income property. This ratio is intended to predict our ability to meet mortgage payments. A presentation to a lender should always include the anticipated Debt Coverage Ratio extended to at least five years.

Fair Market Value—is the most probable price a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition are the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;
2. both parties are well informed or well advised and each acting in what he considers his own best interest;

3. a reasonable time is allowed in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto;
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions

*Granted by anyone associated with the sale. *adjustments to the comparables must be made for special or creative financing or sales concessions.

Gross Rent Multiplier (GRM)—is the simplest way to obtain cursory estimates of the value of a property. This method compares the property's sale price with its current gross annual rental income to determine whether the income will cover your new mortgage and operating expenses.

The gross rent multiplier is calculated using the following formula:

GRM = Sale Price/Property Value divided by the Gross annual rents.

EXAMPLE:

\$150,000 (Sale Price/Property Value) divided by \$19,800 (Gross Annual Rents) = 7.58 (GRM)

Sale Price/Property Value = Annual Gross Rents multiplied by GRM

EXAMAPLE:

\$19,800 (Gross Annual Rents) multiplied by 7.58 (GRM) = \$150,000

Annual Gross Rents = Sale Price/Property Value divided by GRM

EXAMPLE:

\$150,000 (Sale Price/Property Value) divided by 7.58 (GRM) = \$19,800 (Gross Annual Rents)

The higher the gross rent multiplier, the more likely the property will yield a negative cash flow. The property is selling for seven and a half times its annual rental. Investors should note that the gross rent multiplier does not take operating expenses into consideration; this can sometimes result in overvaluation.

EXAMPLE:

Buildings with common heat, electric or water have much higher expenses that those in which tenants are responsible for their own utilities; this dramatically lowers net operating income, but would not be reflected in the gross rent multiplier analysis.

NOTE: GRM analysis should be used only to obtain a rough estimate of the property's value as it relates to income.

Internal Rates of Return (IRR) and Financial Market Rate of Return (FMRR)—are sophisticated valuation methods used when properties have uneven and/or negative cash flows. They usually factor in tax ramifications and a sale of the property at some future date. The IRR uses discounted cash analysis to measure investment yield. The FMRR is a modified IRR that accounts for negative cash flows by using a safe estimated rate to save funds and earn interest in profitable years. Investors should note that IRR and FMRR are based on assumptions that may not be accurately predicted.

Payback Rate—the payback rate is an old-fashioned but widely used yardstick to calculate the owner's return. It simply measures how long it will take for an investor to earn back the investment.

Payback Rate can be calculated by establishing the Monthly Cashflow (Monthly Gross Rents minus monthly expenses and monthly debt service). Then divide investment by Monthly Cashflow to get the number of months then divide by twelve to get the number of years.

EXAMPLE:

\$1,650 (Gross Rents) minus \$880 (monthly debt service) minus \$350 equals \$420 (monthly cash-flow). \$20,000 (Initial investment) divided by \$420 (monthly cash-flow) equals 47.61 months to get you cash back or divide the 47.61 by 12 and get 3.96 almost four years to get your money back.

Price per Square Foot—is a good way to evaluate a property against comparable buildings in the area. Commercial buildings are usually leased at an annual square foot rate. So values are compared by calculating the price per square foot.

Price per square foot is derived by dividing the building's cost by its square footage.

EXAMPLE:

\$150,000 (Buildings cost) divided by 1700 (Building square footage) = \$88.23 per square foot.

Price Per Unit—price per rentable unit is more commonly used on residential rental properties.

Price per unit is derived by dividing the sale price by the number of units.

EXAMPLE:

\$150,000 (Sale Price) divided by three (3) number of units = \$50,000 (Price per Unit)