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3 Popular Ways to Analyze an Investment

<u>1. Gross Rent Multiplier (GRM):</u> The price of the real estate divided by the gross income including the rent and all possible sources of income such as coin operated laundry machines or cellular tower fees.
GRM is derived from comparable properties in the marketplace and may be adjusted to reflect the investor's specific requirements.

*Formula: Sales Price / Annual Gross Income =
Gross Rent Multiplier*

Example: Lena, an Investor receives information on a six-unit apartment building which generates monthly income of $850 per unit plus $75 for the on-site laundry room for a total of $5,175. After Lena annualizes this figure to $62,100, she divides the gross income into the asking price of $800,000 for a GRM of a little over 13.

This is the most simplistic approach and often used to quickly evaluate multi-family properties. A higher GRM achieved is better for the Seller.
The biggest disadvantage of only using the GRM approach to investment analysis is that it fails to consider the effects of vacancy and credit losses, operating expenses, and financing. Also, it looks only at a one-year forecast when determining value.

<u>2. Direct Capitalization Rate:</u> Direct capitalization is a process of converting a future income stream into a present value (PV) by dividing a future income amount by a "cap rate."

Formula: R = I/V *Where: V = Investment Value*
I = First Year NOI
R = Cap Rate

Or: V = I/R

NOI (Net Operating Income) is defined as: Projected Rental Income + other sources of income generated by the property (e.g. coin-op laundry) minus vacancy, credit losses, and operating expenses.

Example: Commercial Agent, Dave sends his clients, Tom & Lou Jean, information on a single tenant light manufacturing facility made up of 10,000 square feet of rentable space. The property has seven years remaining on the lease for an effective rate of $0.65 per square foot on a modified gross basis per month for a total of $6,500, or $78,000 per year. The Seller's recurring operating expenses including property taxes, insurance, common area maintenance and management fees are $19,500 annually. What's left before the mortgage and income tax is $58,500 otherwise known as the net operating income (NOI). Since the asking price is $900,000, the "cap" rate is 6.5%. Because Tom & Lou Jean feel that the property is in a high risk area which warrants a 7.5% return, they reverse the procedure and divide the NOI into the desired cap rate for what they are willing to pay. In this case, the Dave submits an offer on behalf of Tom & Lou Jean for $780,000.

The direct capitalization approach is superior to GRM because it does account for property taxes, insurance and other operating expenses. However, it does not account for debt servicing (mortgage payments), one-time capital repairs/improvements or the impact of income tax. It also only looks at a one-year "snapshot" of the property's performance.

3. Cash-On-Cash Return: Cash-on-Cash is another approach to determine investment value or measure investment performance. It goes further than the Cap Rate approach because it does take into account debt servicing, one-time expenses. However, it also only looks at a one-year "snapshot" of the property's performance.

A. Determining Value:

First-year **cash flow before taxes (CFBT)** /Cash on cash (yield) = Initial Investment.

Initial Investment + Loan Amount = Value

B. Measuring Investment Performance:

First-year CFBT/Initial Investment (i.e. hard cash invested) = Cash-on cash yield

Example: Michele, an Investor committed $100,000 in a 30% down payment for a 1,667 square foot retail building in the heart of Old Town Monrovia. She also had to pay Hal, the roofing contractor $5,000

and come up with $7,000 in escrow closing costs. Her out-of-pocket for the deal is $112,000. Because the property generates $20,460 per year after the annual net expenses and mortgage are taken into account, Michele's before-tax Cash-On-Cash return is 18.27%.

The Cash-On-Cash method goes further than the Cap Rate approach because it does take into account debt servicing. However, it also only looks at a one-year forecast when determining value or measuring performance.

Some investors may require more comprehensive methods of valuing property and/or measuring performance which include extensive forecasting and analysis. These methods include discounted cash flow approaches such as **Internal Rate of Return (IRR), Net Present Value (NPV)**, and **Capital Accumulation Comparison**.

For a further discussion of these approaches to performance and value, you are welcome to contact me.

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