ANNEAL BUSINESS COACHING

How to Evaluate an Income Producing Real Estate Investment

TAKE THINGS ALWAYS BY THE SMOOTH HANDLE.

HOW TO EVALUATE AN INCOME PRODUCING REAL ESTATE INVESTMENT

Virtually every business coaching client I've had is interested in outside investments. That's no coincidence, because if they aren't already interested, I encourage it.

The idea is to use the business to generate income, to use part of the income to build value in the business and part to build wealth outside the business. This is a great strategy for a number of reasons, not the least of which is that it provides a hedge against the ups and downs of the business itself.

THE OBVIOUS INVESTMENT

We can't talk of investment for long before the subject of real estate comes up. There are a lot of reasons to like real estate investments, but the two most obvious to me are, first, it is well understood and established.

There is (usually) an abundant market of buyers and sellers. The processes, principles, and documents used for buying, selling, and renting real estate are well established, as are those for lending and borrowing to buy it. Investors don't have to create the market or invent the processes. Real estate offers the chance to, in Thomas Jefferson's words, "Take things always by the smooth handle." That is a big advantage compared to running a business.

Second, real estate is the gold standard of opportunities for harnessing the awesome power of financial leverage by using borrowed money to earn higher returns.

We'll look at how much higher below.

THE DEFINING QUESTIONS OF REAL ESTATE INVESTMENT

We could almost say that making money in real estate is automatic, but that would be going too far. There are risks, but if the original investment is done right, real estate provides a better risk reward ratio than most other investments.

Investors need only be disciplined in their buying, have time to allow the investment to produce and understand some important principles. That last point is where the Real Estate Investment Calculator comes in.

The calculator helps to answer the two defining questions for an income producing property investment:

1. "Based on the price, my research, and my assumptions, is this property likely to make a profit?" and

2. "Will this investment cash-flow?"

The calculator is designed to evaluate properties to be purchased, held and rented. It is not designed to evaluate our personal homes or "flips."

Before we get started with the calculator, we should be clear about a few terms:

1. Profit,
2. Cash Flow,
3. Return on Investment (ROI),
4. Equity, and
5. Leverage

PROFIT

Everybody knows what a profit is - it's when income exceeds expense. Simple enough. But there is confusion about expenses when borrowed money is involved. Utilities, maintenance, insurance, property taxes and the like are expenses. Loan payments to the bank are a different story. The interest is an expense, the principle is not.

That's an important point. Debt payments in real estate deals are usually the largest single monthly expenditures. The notion that we might expense the whole payment lures many of us into thinking we will have a loss for tax purposes and therefore won't owe income taxes.

But surprise!

When our accountant corrects our assumption at year end, we can wind up owing significant income taxes, even if there's no money left to pay them. The calculator helps prevent this common misconception from distorting our evaluation of a deal.

CASH FLOW

Cash flow can be positive or negative.

Positive cash flow means the investment generates enough cash to pay all of our obligations including expenses, income taxes (which also are NOT an expense) and principle payments. Negative cash flow means it doesn't.

If rent won't pay our obligations, we will be stuck putting more cash into the deal. That's not good. It is possible to earn a profit and a great return on investment with negative cash flow, but believe you me, positive is better. The calculator helps us choose only deals with positive cash flow.

RETURN ON INVESTMENT (ROI)

Our investment in a property is the money we put in. It does not include money we borrow.

Real estate investments earn a return on our investment in two ways: Through operating profits and through appreciation of the property over time.

Appreciation is profit but is not recognized as such until we sell the property. Our total return on investment is operating profit plus appreciation divided by our investment. Appreciation often contributes the largest portion to our return on investment.

EQUITY

When we add up what we own and subtract what we owe, what's left over is equity, or our share. Over time, as we repay the principle of our bank loans, our equity increases. It is essentially a savings account paid by our renters and supplemented by appreciation.

LEVERAGE

Leverage is using a tool to gain advantage, and in real estate the tool is borrowed money.

For example, if we have $200,000, we can buy a $200,000 property outright, or we can use it as a down payment to borrow another $800,000 and buy a $1,000,000 property. I'll spare you the math (that's what the calculator is for), but returns on investment from a $1,000,000 property, even diminished by interest expense, will be more than we would expect from a $200,000 property.

We'll see how much more below.

THE GOAL

The goal of an income producing real estate investment is to buy property using borrowed money that renters repay for us. We should shoot for investments that earn a profit, provide positive cash flow, and will appreciate significantly to give us an above average return on investment.

Sounds like a pretty good plan, doesn't it?

It is, if we buy the right properties. The calculator helps us choose.

To see how it all works, download the calculator and enter the example information below.

EXAMPLE INFORMATION:

PRICE PAID - $500,000

The all in price of the property including price, closing costs, inspections, etc. This is the amount we will write checks for to purchase the property.

IMPROVEMENTS - $100,000

The cost of anticipated improvements to the property. (The amount we borrow will be the price paid plus improvements minus the down payment.)

DOWN PAYMENT - 20%

This is the percent required as a down payment by the lender. (It is also our beginning equity, our investment in the property.)

TERM YEARS - 15

The term for the loan from the bank.

ANNUAL INTEREST RATE - 5.0%

The annual percentage interest rate on the loan.

OCCUPANCY RATE - 90%

Income, profit and cash flow all depend on rent. It would be great to plan for 100% occupancy, but that is seldom realistic.

MANAGEMENT FEE - 0%

Property managers typically charge a percentage of rental income for their services. Enter their fee as a percent of revenue here.

RENTAL INCOME PER MONTH - $7,500

The anticipated monthly rental income if the property were 100% occupied.

REAL ESTATE TAXES PER YEAR - $8,000

This is the property tax for the full year. It does not include income taxes.

INSURANCE PER YEAR - $7,500

The liability, property and any other insurance cost directly attributed to the property

MAINTENANCE PER MONTH - $200

Maintenance often varies by season, but divide our total maintenance budget for a year by 12 to get a monthly number to enter here.

RENT INCREASE PER YEAR - 2%

Our estimate of an average rate of rent increases.

ANNUAL APPRECIATION - 3%

The rate at which we expect real estate to appreciate in our area.

INCOME TAX RATE - 25%

This is the marginal income tax rate for the entity or person who will pay taxes on profits from the property.

OTHER EXPENSES PER YEAR - $0

The next two cells are for other annual expenses we anticipate, if any.

RESULTS

The detailed results of the information we just entered are shown in green on the calculator.

Notice that, if our assumptions are right, this investment will produce a profit of $531,288 over ten years, has positive cash flow, grows our equity from $120,000 to $724,816 in ten years, and produces a ROI ranging from 48% per year up to 76.2% per year. All of this as a result of our original $120,000 investment. Not bad.

Now try it with information for your project. If you don't have the necessary information, get it.

HAVE FUN WITH THE CALCULATOR

Play with the Real Estate Investment Calculator. If you don't like the results for your project, or even if you do, change your numbers.

Use the calculator to refine your judgment and define your offer. See what happens if you reduce your offering price, pay more or less down, pay your loan over more or fewer years, find a slightly better interest rate, and so on.

You may not be able to purchase the property on your terms, but you will know what your terms need to be, and you may avoid a big mistake.

THE AWESOME AND DANGEROUS POWER OF FINANCIAL LEVERAGE

You'll notice I added "dangerous" to the description of leverage. That's because there is danger in leverage because it involves borrowing money. Borrowers accept the danger in exchange for the opportunity to earn significantly higher returns.

A reasoned assessment of risks and rewards requires us to understand how much higher leveraged returns might be in exchange for the risk of debt. The calculator can tell us.

To see how, try this simple exercise.

In our example calculation, we put down 20% ($120,000) of the cost of the project and leveraged the balance by borrowing. As we saw above, and can see in the ROI column at the bottom of the calculator, our leveraged ROIs ranged from a low of 48% to a high of 76% annually.

To find the comparable, unleveraged return, enter "100%" in the downpayment cell on the calculator and compare the results. Surprised? The difference between the two is the power of leverage and our reward for accepting the risk of borrowing.

HOW ABOUT YOU?

Have you considered income producing real estate as an investment? Does the calculator make sense to you? Are the Real Estate Investment Calculator and explanations clear? If you have any further questions, please don't hesitate to mail me at Martin@annealbc.com or visit www.annealbc.com

Martin Holland

Martin Holland is the son of a successful entrepreneur. He grew up hearing about margins and markets, R&D and sales, risk and return on investment. He learned to love the language and rigors of business and grew to believe that business is both the most human of all endeavors and the highest calling. After selling a company in 2011, Martin became a coach in order to help other owners build profitable businesses that do not require their day-to-day involvement.

A native of Norman, Martin earned a B.A. degree from Hastings College in Hastings, Nebraska and a Masters in Business Administration degree from the University of Oklahoma. Over the past 7 years he has written business plans that have raised over $52.4 million in bank and investor financing. He has helped 157 (and counting) business owners reduce stress and increase performance through clarity of purpose, better marriages, more money, and more free time away from the business.