

# INVESTMENTS:

## Don't Just Check One Metric When Evaluating Property

### PART I OF A 2 PART SERIES

There are many different metrics used to evaluate investment properties. Investors will analyze a property's *gross rent multiplier*, *cost per unit*, *cost per square foot*, *CAP Rate* or *Cash-on-Cash return* or one of several other measures. Often, investors will find a "favorite" metric to use and will ignore others in favor of just that single one. This month, I will review the strengths and weaknesses of each of these indicators to show why you should always use multiple measurements for property reviews. As I wrote this article, I realized that a good review of the basics will take much more space than I anticipated. Consequently, this article is split into a 2 part series, with the conclusion running next month.

#### Gross Rent Multiplier

The Gross Rent Multiplier can be abbreviated as GRM and is often used to describe the price of apartments. It represents a measure of how much a buyer is paying for each dollar of rent that comes in. For example, a single family home purchased for \$400,000 and rented for \$2,200 per month (\$26,400 annually) has a GRM of 15.15. ( $\$400,000 / \$26,400 = 15.15$ .) Using this metric as a comparison point, a home that costs \$350,000 and rents for \$2,000

per month, (\$24,000 annually), has a GRM of 14.58. Using the GRM method alone, the \$350,000 home looks to be the better investment because a buyer is paying \$14.58 for every dollar of rental income that the home produces versus \$15.15 for the more expensive home.

The big shortcoming of the gross rent multiplier method is that it ignores the impact of expenses on income. Landlords are, in effect, business owners and every business owner is less concerned with how much he sells (gross revenue) and is more focused on what he keeps - his net income. (Gross income – expenses = net income: what money gets to his pocket.) In the examples above, we have no idea what the expenses of these properties are. What does annual maintenance cost? How much is insurance? What are the property taxes? (It is possible that, with special assessments or "mello roos," the less expensive house could have higher property taxes.) If these houses were, instead, apartment buildings; where such expenses aren't as easily passed on to tenants, what are the utility and landscaping charges?

Expenses will have a huge impact on the success or failure of your real estate investment. The main



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defect of the gross rent multiplier calculation is that it ignores this important data entirely.

### Cost Per Unit

Cost per unit is another unit of measure that is mostly used for judging the value of apartments. Some brokers will use “cost per door” as a synonym for this measure. The shortcoming of the cost per unit measure is that it doesn’t take any income information into account. For example, I was reviewing an apartment property recently that offered apartments at an attractive-sounding \$121,000 per unit. After performing some math, I found that the property’s CAP Rate (a measure of value versus net income) was a mere 4.2%. (A buyer of this property for all-cash would net a 4.2% cash on cash return.) The cost per unit of this property is actually too high relative to the amount of rent that the units leased for – I wouldn’t pay over \$100,000 per unit for that particular property in today’s market.

### \$ Per Square Foot

The price per square foot method can be useful in some cases – but only when comparing “apples to apples.” The main drawback of this method is that it doesn’t account for variations between properties. For example, a 3,000 square foot two bedroom, two bath single family residence (a house) will very seldom be worth the same amount as a 3,000 sf, 5 bedroom, 4 bath house located next door. If the 2 bedroom house is on the beach in Malibu and the 5 bedroom house is in Columbus, Ohio, however, *of course* it will be worth more. The \$ per square foot comparison is of little use when comparing any of those 4 deals. Similarly, the \$ per square foot measure can be useful when comparing apartments in the same market, but not with apartments in different ones. (Renters will pay more for a small apartment in Newport Beach than they will for a large one in a less

expensive area.)

This metric can also be misleading when comparing retail properties. Let’s pretend that a stand-alone casino existed on the Las Vegas strip in Nevada. (I’m not sure why nobody has thought of that before.) Since casinos generate huge revenue from the gambling losses of their customers, and because such a property would be in very high demand, a price of perhaps \$750 per square foot may not be much out of line. A potential investor certainly wouldn’t pass on at least reviewing such a property based on a “too high” price per square foot.

### Look for Part 2 of this Series Next Month

Next month, we’ll look at more value metrics that are commonly used when evaluating potential real estate purchases. A more thorough knowledge of these calculations will make you a smarter real estate investor – one who can do a better job of evaluating potential properties. As many wise investors have said; “you make your money when you *buy*, not when you *sell*.” If you have any questions, please call me at (877) 313-1868. Until next month, enjoy the rest of your summer!

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# INVESTMENTS:

## When Evaluating Properties, Don't Just Use one Metric

### PART 2 OF A 2 PART SERIES

**M**y article this month is part 2 of the “Don’t Just Use one Metric” article that ran in September. As I said in September, there are several different metrics one can use to evaluate a potential real estate investment. In my day-to-day interactions with real estate investors, I see that sometimes an investor can pick his “favorite” metric and ignore others. This could be a mistake – those others may hint that the property isn’t such a good buy after all.

We reviewed three commonly-used metrics last month, and we’ll talk about 3 more now:

#### CAP Rate

The Capitalization Rate, or CAP Rate – not to be confused with Cash on Cash Return – is a very popular measure. A property’s CAP rate is an indicator that estimates how much one is paying for every \$1 of income: The higher your CAP Rate, the lower your cost is. A property’s CAP Rate can be calculated by:  $\text{Net Operating Income} / \text{Purchase Price} = \text{CAP Rate}$ . So, a property with an NOI of \$100,000, and a purchase price of \$1,000,000 has a 10.0% CAP Rate. ( $\$100,000 / \$1,000,000 = 10\%$ .) A property with an

NOI of \$200,000 and a purchase price of \$1,000,000 would have a 20% CAP Rate.

To use the CAP Rate measurement, you’ll need to understand what Net Operating Income (NOI) means. A property’s Net Operating Income is its Income minus Expenses, (but NOT including loan payments or capital costs). For example: An apartment property with \$148,000 of rental income, \$2,000 of laundry income, \$50,000 of expenses, \$36,000 of loan payments, and \$100,000 of capital costs (a new roof was added during the year) would have an NOI of  $\$148,000 + \$2,000 - \$50,000 = \$100,000$ . (Loan payments and capital costs aren’t counted.)

In the above example, you’ll see that some rather large numbers are ignored entirely. This is because the CAP Rate calculation recognizes that loan variables will be different for every investor. Down payment size, interest rate, and loan term will all probably be 12 different numbers for 12 different investors. Therefore it is most efficient to analyze properties separate from any loan figures. Adding capital costs information to the CAP Rate calculation would skew the results so much as to limit the usefulness or any



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result.

When using the CAP Rate metric to evaluate properties, it is important to recognize these shortcomings – that loan or capital cost figures are ignored.

### Cash on Cash Return

A property's Cash on Cash Return is what I call an investor's "mailbox money." Your cash on cash return is what you are left with after ALL expenses are paid for. For example: let's say that the property mentioned above has a \$500,000 loan on it for an annual debt service cost of \$36,000, and that we have property valued it, with a 6.1% CAP Rate, at \$1,639,344, leaving us with \$1,139,344 of equity in the property. Let's pretend, for this example, that the roof repair didn't happen. This will leave you with  $\$148,000 + \$2,000 - \$50,000 - \$36,000 = \$64,000$  of mailbox money. If you take \$64,000 and divide it by your equity in the property, you'll calculate your cash on cash return – in this case; 5.6%. ( $\$64,000 / \$1,139,344 = 5.6\%$ ).

Now that the investor above knows his cash on cash return, he may want to look at places to exchange that equity to seek a higher rate of return.

This month's article, along with part one from September, offers a good review of the basics behind many popular real estate evaluation metrics. All of these indicators have their advantages and disadvantages – understanding their strengths and weaknesses is the key to using them successfully. Often, more than one should be used for the best guidance. If you have any questions about these, feel free to call me at my office: (877) 313-1868.

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