



Cap Rates Or Cash on Cash Do you speak Investor?

3 Hours CE.7322000-RE – General



Cap Rates or Cash on Cash Course Objectives

As a result of this session:

- 1) Participants will learn the **terms** most widely used by real estate investors.
- 2) Participants will examine **Investment Options**.
- 3) Participants will be able to **explain** the following concepts:
 - a. Capital Pool - How much is **enough?**
 - b. Liquidity - The ability to CONVERT to cash
 - c. Leverage - BOTH Positive and Negative
 - d. Yield/I.R.R. – The return **OF AND ON** the investment
 - e. Imperfect Market Concept – **CREATE** Value
- 4) Participants will discuss the relative benefits and shortcomings of the different **methods of evaluating** an investment.
- 5) Participants will determine the G.R.M. in 4 examples.
- 6) Participants will go over a “line by line” explanation of an A.P.O.D.
- 7) Participants will complete an A.P.O.D. using a case study.
- 8) Participants will evaluate **Local Market** factors.
- 9) Participants will “Role Play” an Investor Interview using “Pre-Scripted” questions



Let's Pretend:

Assume you had \$4,000,000 to invest – make a list of your OPTIONS:

Now – looking at the OPTIONS – identify the strengths and weaknesses of each:

If YOU PERSONALLY were asked to pick TWO of the above investment options – which two would you pick?

Appendix “1”

There are THREE things needed to make an investment:

Capital

Knowledge

Opportunity (which includes simply having the *time* to find the deals)



Six “Concepts”

1) Capital Pool

Whether it is from savings (fat chance), an insurance policy, an employer plan or good old fashioned investing – the TOTAL AMOUNT of wealth you have built up by the time you quit working is your “Capital Pool”. This will be what you depend on to generate your “Standard of Living” from now until the dirt nap.



2) Time Value of Money – A Dollar 5 Years from now?

Would a BANK loan you \$100,000 and let you pay them back \$100,000 ten years from now? Because the Bank’s money has the “potential” of earning interest – there exists an “opportunity cost” of money – even if that money is YOURS.





3) Yield – Figuring Rates of Return

A more complete explanation of this is provided in the appendix – but simply put – the Higher the Yield – the more you’ll have in your “CAPITAL POOL” noted above.

Hint: More is Better!

Question: If you had \$40,000 and you had TWO options to invest the money –

One - \$40,000 @ 5% or , two @ 8% both for 15 years – both accruing (no payments for the term) – How much difference would there be in the Capital Pools? – Pick a, b, or c.

- a) 1 - \$83,157 vs. 2 - \$126,886 for a difference of \$43, 730
- b) 1 - \$75,420 vs. 2 - \$101,670 for a difference of \$26,250
- c) 1 - \$64,315 vs. 2 - \$79,093 for a difference of \$14,778

4) Liquidity and Leverage

Liquidity simply put is – “**the ability to convert to cash**”. Some investments are considered more liquid than others so some investors will pay more for that characteristic thus driving the Yield **down**.

Leverage – the ability to Own/Control the asset using OPM. The EFFECT of leverage is that it magnifies the %’age return **or loss** of the investment.

Question: Do you need ALL the money to buy Stock?

5) Tax Considerations

“Don’t let the tail wag the dog.”

Tax laws change! While it is “real world” to take Tax Considerations into account – be careful not to put too much weight in this area.

And, remember to advise your client to seek Professional Help – Taxes are NOT within your scope of expertise.

****Special NOTE:** - Even if you are NOT a Tax Expert – as a licensee you should be AWARE of special rules e.g. I.R.C. 1031 Exchange provisions and F.I.R.P.T.A. rules if your client is a Foreign Investor/Resident..



****6) Imperfect Market – CREATING Value!****

By FAR the most important aspect of investing – especially for Real Estate!

The more uniform the asset – and the more widely held – the more perfect the market for that asset. For example each share of IBM common stock is pretty much like every other share of IBM common stock so it is very uniform. Further it is widely held – and easily valued – if you'll take whatever someone is willing to pay, as published daily in the paper – you can sell it instantly (and with relatively little costs of disposition).

Question: If you are a superior negotiator will you get more than is offered in the paper?

Compare IBM stock with Gold – Gold is less widely held – a little tougher to market but still relatively liquid and uniform – each 14 karat bar or Krugerrand is like every other.

Question: Does the *reason* the seller is selling the Gold impact the value?

Compare Gold with Diamonds – less uniform – 5 C's to consider – major difference between retail and wholesale.

Question: Would Diamonds be *more perfect* than Rubies? Why?

Compare Diamonds with Other Collectibles e.g. Classic Cars or Coin Collections – what factors do you look at?

Question – How much does the emotional factor play in the valuation?

So let's consider Real Estate:

Each piece is _____.

The _____ situation impacts asking price.

_____ have an impact.

Your _____ skill has an impact.

The use of _____ and _____ impacts the

Price/Payment and Value.

Costs of _____ have an impact.

Management issues have an impact.

_____ of the market has a bearing.



Basic Vocabulary – Terms you must know!

Capital Pool – The concept that when you retire your income will need to come from a POOL of investments/capital

A P O D - **Annual** Property Operating Data (a form).

C.F.A. - Cash Flow Analysis – a *form* to determine Cash Flows over a period of years – Takes into account “Acquisition – Operation and Disposition” and the Tax Impacts of each in turn.

G.R.M. – Gross Rent Multiplier

Cap Rate - The return on the investment expressed as a %'age.

I.R.R. - Internal Rate of Return – A Formula for determining a Rate of Return over a period of time using ALL the Cash In & When and ALL the Cash Out and When – Accounts for the “Time Value” of money.

RISK - Real and/or Perceived

Diversification – Do you put ALL your eggs in one basket?

Liquidity – The ability to convert to CASH

Rent Survey – Who makes the call?

Debt Coverage Ratio – What a LENDER looks at

Utility -

Leverage - Controlling the Investment *without* ALL the money.

Emotional Considerations...& Imperfect Market

Note: See Appendix 2 Measures



G.R.M. – Gross Rent Multiplier

- 1) A Single Family Home rents for \$950 per month. If the G.R.M. is 12 – what would the Sales Price be?

- 2) A four-plex rents for \$650 per unit. The vacancy factor in the neighborhood is 7% but this building is fully rented. Using a G.R.M. of 10 – what would it sell for?

- 3) A Condo is asking \$240,000. If the G.R.M. was 10 – how much would the rent have to be PER MONTH?

- 4) Two properties in the same neighborhood – one has a G.R.M. of 12 and one has a G.R.M. of 10 – both are rented at the same monthly price. Which is the better value?

What questions would you want answered *besides* the G.R.M. to help determine which property would be the better investment?

G.R.M. vs. Cap Rate – “What’s the difference?”

****Note: See appendix**

G.R.M. is SIMPLE – all you need to know is the projected rent.

Cap Rate is the N.O.I./Sales Price: *requires* you to know or *project* (or worse – guess at) the expenses of the property (excluding debt service).

You could easily have more than one property at a certain G.R.M. but that doesn’t tell you anything about the *condition, terms/financing* or the *age* of the property – or the *area*.

Cap Rate also ignores *age & area, financing* and *management intensity*.



A.P.O.D. ANNUAL Property Operating Data

****Note: See appendix 3 for sample form**

There are generally THREE TYPES of *Projections* reduced to writing on the APOD.

The first is the **Owners Statement** – which means the **current Owner**. Now, you may question whether ALL the expenses are on the form – and why there is NO management fee – and NO VACANCY factor...

The second is the **Accountant's Statement** – which means what the **Owner** reported to the I.R. You might notice that the Gross Income was a *little* lower than the previous projection – oh, and the *expenses* were higher than the previous projection. I guess it was just an unbelievably bad year.

The third is the **Brokers Projection** – YOUR NAME goes on this one so be very cautious about your numbers. Where did they come from? Where did you get the **Vacancy Factor**? Do you cite the source? Did **the Buyer** do a **rent survey**? Do the **Real Estate Taxes** change upon transfer or is there a periodic re-valuation by the County Assessor (and if so – does it happen to be coming up any time soon)? Did you check/verify the **insurance** cost? Which **Management Company** is the Buyer going to use and are there **set-up** fees as well as **rent collection and re-rent** fees?

Case Study – Use Blank Form Appendix 3

The buyer is interested in a SFR with an asking Price of \$170,000.00 Using the MLS – you run a Search of rentals and you find there are only two vacant SFR's in the immediate area that are comparable and both are asking \$1,200 per month. Property taxes are \$1,650 per year. The Management Company charges 10% of the rents collected plus a \$450 rent-up fee but NO set up fee. You call the **Buyers** insurance agent and she quotes \$950/yr. on a rental property for Hazard Insurance.

The Buyer is going to put 30% down and finance the balance **fixed rate** on a 15 year loan @ 6.25%

****Remember to fill in the Date and Property Address!**



The following assumes a NEW first phase home that has a one year BUILDER Warranty + a 4 year home warranty extension package. If Resale turns out to be a better choice – you must get a 1 year home warranty.

Real Estate is a LONG TERM investment and because of disposition costs, can actually LOSE money if you sell too soon. Neither past performance, nor your agent, guarantees **future** financial performance.

Sales Price	
Down Payment (25%)	
Closing Costs/Upgrades (5%)	
Total Cash Invested	
Monthly Payment @ 7%	
Taxes and Insurance	
<i>POTENTIAL</i> Rental Income * After Management Fee	
Cash Flow From Property	
– Monthly Payment	
<u>ANNUAL</u> Positive or Negative	

First Year LOSS?

Depreciation (*currently*) is approximately 75% of Sales Price / 29.5 years



Loss for Tax Purpose

@ _____ % Tax Bracket
(real return)

Principal Reduction

Appreciation @ _____ %/yr

Total Return

Total Cash Investment/Return

Will Property Values be higher in 15 years?

Will Rents be higher in 15 years?

If I had a 15 year mortgage – and ALL the *extra* (every penny) went towards paying off the loan faster AND it saved me on interest ... But was a little more painful in the short run ...

Even after Management and reserves for Repairs/Replacement and maintenance – how much of a check could I expect to receive each month in the mail?

Is it **MORE** risky to DO NOTHING?

Next Up – Analyzing the LOCAL Market & Counseling the Client

Important Principle: People’s emotional characteristics OUTWEIGH financial considerations.

Concept

The three items necessary before an investment can be made.

1. The Capital
2. The knowledge/the ability to determine a rate of return
3. The opportunity



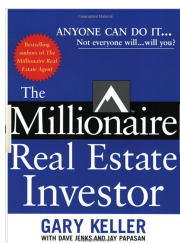
Analyzing the LOCAL Market Dynamics

Fact: “All Real Estate Is Local.”

What should we look at AND show to potential investors before they make a purchase decision – and where do we GET this information?

Work with your partner and come up with two ideas each on what you could show to an investor...

Remember to be the “Source of the Source – NOT the Source.”



Pg. 63; “If you look up “invest” in the dictionary, you’ll find: ‘Invest – to commit (money or capital) in order to gain a financial return.’ Notice the word ‘risk’ doesn’t appear anywhere in the definition.”

On-Line Sources

Start at www.co.clark.nv.us. --- Click on “Demographics” tab

Links to Federal Stats

Nevada Development Authority – N.D.A.

U.S. Census Bureau - Census.gov

* The Census Bureau reports Las Vegas’ median family income of \$53,000 was 5th for cities above 500,000 populations

U.S. Dept. of Commerce – Bureau of Economic Analysis

Statistics Available from N.A.R. Realtor.com for the public and Realtor.org for Realtors®

Statistics from U.N.L.V. – Business & Econ. Dept.

<http://cber.unlv.edu/pub.html>

Local News Sources e.g. R.J. & Business Press

*McCarran is now the 5th busiest U.S. airport behind JFK, Atlanta, Chicago/O’Hare and LAX.



Investment Strategies

Investor Profile Analysis

The purpose of these questions is to determine which investment strategies may be best for you at this time.

1. Does your company have a pension plan?
2. Do you have a Will or a Family Trust?
3. Do you have a financial plan? Are you using a financial planner?
4. What made you talk with us today?
5. Do you currently have an IRA, Keough or other type of self funded retirement plan?
6. What other types of investments do you currently have?
7. Are you interested in a short term investment or a long term investment?
8. What experience have you had in buying or selling real estate – either personal residences or investments?
9. Would you consider yourself to have a high threshold of risk tolerance or a low threshold of risk tolerance?
 - a. If you could invest your money safely at 6% or with a small amount of risk at 9% which would you choose?
10. What kind of insurance do you now carry?
 - Health & Disability
 - Term Life
 - Universal Life/Hybrid - Risk/Investment Combination
11. How much were you planning on investing and how diversified would you prefer to get?



Questions to Consider...

Are you paying too much in taxes?

Are you going to retire someday? (Do you have *kids* that will take care of you?)

If someone showed you a way – that YOU believed would greatly increase the odds of you being financially independent – would you take action?

Do you know what tax bracket you are in?

Do you currently invest in an IRA or Company Pension program?

What has been the best investment you have made thus far in your financial life?

If you saw something that was an absolute opportunity – an almost sure-fire winner, but you didn't have enough capital – can you think of one person (that has money) that you could get to go in with you?

If you had to pick a number – what % do you think Real Estate would appreciate annually over the LONG TERM?

Do you see inflation as a possibility at any time in the next 10 to 15 years

Do you think that *emotionally* you are strong enough to buy a property – rent it out – and leave it alone to work for you?

“Never *tell* them something you can *show* them!”
Sample Property ...



Investment Strategies

Checking the Learning!

- 1) What is a Gross Rent Multiplier?

- 2) List two weaknesses of the Cash on Cash method of measuring return on investment.

- 3) N.O.I. is defined as ...

- 4) There are two kinds of risk – name them.

- 5) When is the right time to sell? (Hint – there may be more than one right answer.)

- 6) List THREE major reasons to invest in Real Estate;

- 7) YIELD or I.R.R. takes into account both the return _____ the investment and the return _____ the investment and takes into account the ‘time value’ of money.

- 8) On an APOD – if the _____ factor is wrong the entire projection can be *very wrong!*