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Proforma not looking sexy?

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I have been working with the real estate investors since 2003 and have witnessed varied forms of evaluating a property one might intend to invest in. The most common approach is the cash on cash return model determining the rate of payback for the funds invested. Most proformas have this built into its auto calculating capability resulting in a typical single digit return in today's tight inventory/ higher rate environment. Although it a great metric, It seems to not explain the entire story. I have seen many an investor walk away from a better deal than what their cash on cash return model explained.

I tend to go very simple with the numbers as I am a very simple person and use basic principles in all facets of life and business. Wanting to find a more elementary way to evaluate I started looking at the very basic numbers on a potential investment property purchase. Being that I am a fan of the 30 year fixed loan I figured no simpler instrument to start with. Let's apply some straightforward math and see if this makes sense to more than just me. We will start with the following assumptions as a baseline (based on a loan I am presently working on for an investor)-

- $100,000.00 Acquisition Price
- $20,000.00 initial investment (20%)
- $80,000.00 Loan
- 1% rent to value Ratio ($1000.00)
- $5500 in appx settlement (Title fees, Lender Fees, Taxes, Insurance, Inspections, Appraisal etc)
- 8% property management fees
- 611.86 PITI
- $388.14 Per month cashflow NOT counting maintenance and vacancy

Looking at this I will ask many investors how much money they spent at closing. Often the sum of $25,500.00 is the provided answer. I beg to differ…Is the $20K really spent? The $5,500.00 went to services, but the $20,000.00 went from a liquid account to a non-liquid asset. It is still theirs, just not in a place they can readily buy a boat with it. With regular rent coming in and regular payments to the loan being made the $20K becomes $100K by virtue of the fact the loan is paid off. Paid by the tenant I might add. That is an $80,000.00 gain. Divide that by 30 years you get an average of $2666.66 per year which is equal to 13.33% of the initial $20,000.00 added to that $20,000.00 until you reach $100,000.00 total.

So let's shelf that part of the return and turn our attention to the money that was actually spent. The $5,500.00. Using the $388.14 per month it is possible to recover the spent $5,500.00 in 14.17 months. At that point an investor has broken even. Since 30 years is equivalent to 360 months and the first 14.17 was used to recover the spent funds there is 345.83 months left to cashflow.

Receiving $388.14 per month for 345.83 months will yield $134,230.45 in income. Add that to the $80,000.00 the actual dollar gains are $214,230.45. That is all without factoring in Rent Raises, Tax Benefits, Appreciation or paying payments with future dollars effected by inflation! I know what you're saying…What about Maintenance and vacancy?

If the investor as the CEO of their new real estate investment firm makes the right decision with respect to buying the right property, and working with the right property management is it reasonable to think that such a property can be maintained and vacancies weathered with 40% of the acquisition price? That is $40K to take care of these contingencies for the 30 years discussed. Many say that can be on the conservative side and the figure is much lower than $40K, so be it…Lets be conservative. Subtracting the $40,000.00 from the $214,230.45 the remainder is $174,230.45. That is one hell of a return and that figure does not including the $5,500.00 put back in the investor's pocket, the $20,000.00 initial investment (still belongs to investor), rent raises, appreciation, tax benefits or hedge against inflation. When plugging in these figures to evidence the return any calculator will provide you the sum of "Damn Ridiculous" as a final figure.

Since I stated above I like to play in the conservative waters. We can beat on these numbers a little more and see what we get. Let's estimate that the monthly cash flow after the Principle, Interest, Tax, Insurance and property management is $250.00. That is a somewhat unsexy number for a 100K property. Especially when Maintenance and Vacancy are not part of the equation yet. Time to calculate-

$5500.00 spent

22 month recovery at $250 per month

338 months left to cashflow (360-22 =338)

$84,500.00 cashflow ($338 months X $250.00)

$164,500.00 income ($84,500 cashflow + $80,000.00 paid off loan)

$40,000.00 Contingency for maintenance and vacancy for 30 years

$124,500.00 total income subtracting the contingency fund of $40K

All together-

$5,500.00 Paid back

$20,000 still invested in the property

$124,500 clear profit

$40,000.00 Contingency

$190,000.00 Total

So we see at even a small income of $250.00 per month this one investment can generate $124,500.00 of profit on top of paying the investor back their $5,500.00 and holding their $20,000.00 in a secure place where their Mr. Hyde consumer cannot take it and buy a depreciating toy.

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