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Real Estate Investment Analysis

Investors use many different approaches to determining the value of a property depending upon their level of sophistication. Some of the more popular include Gross Rent Multiplier, Cash on Cash Return, Cap Rate, Debt Coverage Ratio, and Internal Rate of Return.

Gross Rent Multiplier – GRM. To calculate the GRM divide the asking price of the property by the gross annual scheduled rents. To determine if the property is at a fair market value, compare the property of interest to comparable properties that have sold recently. The GRM is a convenient tool because of its simplicity, but does not take into account vacancy, uncollected rent, operating expenses, mortgage payments, the impact of taxes or income past the first year.

Cash on Cash – COC. Another measure of investment performance is the cash on cash return. The investor's initial investment, which includes down payment & closing costs, is divided by the before-tax cash flow. COC takes into account vacancy, uncollected rent, operating expenses and debt service. It does not take into account tax consequences and it does not consider anything past the first-year forecast.

Cap Rate. Capitalization rates or cap rates are used by investors to determine the value of an investment property. They often depend on the type of property and the location of that property. Cap rates are determined by dividing the net operating income by the value of the property. By comparing cap rates to comparable properties sold in your area, you can determine if the property of interest is priced appropriately.

Debt Service Ratio - DSR. Debt service ratio or debt service coverage ration is a concept unique to commercial lending. More and more investors are looking at this number since lenders use this ratio to determine if there is sufficient cash flow from a property to cover the mortgage payments and to have a surplus of funds available for unanticipated expenses and/or to provide a return to the property owner.

To calculate the ratio, subtract all of the operating expenses from the adjusted gross rental income. Be sure to include a 5 to 10% vacancy factor (depending on your specific location), 5% management fee and 5% for maintenance & repair expenses and 2-3% for capital reserves. Divide that figure, the net operating income, or NOI, by the monthly mortgage payment for principal and interest.

Most lenders use a debt coverage ratio, of 1.2 for multi family properties. Ratios of 1.3 are common for other types of commercial properties. If the property is owner occupied, many lenders will use a lower ratio.

If the DCR does not meet the required ratio, there are a few lenders that will take into account your own disposable income to assist in making the commercial loan payments and your personal debt to income ratio plays a key role.

Internal Rate of Return – IRR. The internal rate of return has been used in the past only by sophisticated investors. Today, with the advent of inexpensive real estate analytical software, this approach is now being used by the novice and intermediate investor.

This method is used by investors to decide whether they should make long-term real estate investments and to compare properties of interest. The IRR is the return rate that can be earned on the invested capital, i.e. the yield on the investment. A project is a good investment proposition if its IRR is greater than the rate of interest that could be earned by alternative investments (investing in other projects, buying bonds, even putting the money in a bank account). The IRR should include an appropriate risk premium.

Generally speaking, the higher a project's internal rate of return, the more desirable it is to undertake the project. As such, IRR can be used to rank several prospective real estate purchases an investor is considering. Assuming all other factors are equal among the various properties, the property with the highest IRR would probably be considered the best and should be purchased first.

You can think of IRR as the rate of growth a property is expected to generate. While the actual rate of return that a given property ends up generating will often differ from its estimated IRR rate, a property with a substantially higher IRR value than other available options would still provide a much better chance of strong growth.