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CAP rates and rates of return: Understanding what happens to the dollars you invest

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One of the few ways to analyze an investment of any kind is to understand what happens to the dollars that you invest in the investment. The CAP rate is the first step. Direct capitalization is the process of converting a one year stabilized net operating income (NOI) into a market value of the property that you are analyzing.

Let's say you want to purchase a 20-unit building. Take the annual gross rental income, less an amount allocated for vacancy and credit loss. This should be factored in even if there are no vacancies. Some day there will be and having monies put aside for loss of income will be important. Subtract expenses such as property taxes, insurance, utility costs, maintenance and 5% for management. This subtracted total is the properties Net Operating Income.

When you divide the list price by the NOI you will get the CAP rate. If the CAP rate is greater than the cost of mortgage funds rate, then you will be able to achieve positive leverage on this investment.

Use this method when comparing multiple properties and determine which may have the best future value by increasing rents and decreasing expenses. Think about how the property will be performing in five years and forecast what the NOI might be at that time.

Its future value will be based on what CAP rates are and how high the NOI is on your investment.

Cash on cash rates are a simple way of looking at an investment. It is calculated using the first year net cash flow divided by the initial cash invested. That method is a quick way of looking at a simple investment. Let's say you want to purchase a single family house and rent it out. How much money will you need to invest in the property upfront and divide that amount by the amount a positive cash flow the property will generate after the first year.

In order to determine the Internal Rate of Return on your investment over the holding period you will need to calculate the cash invested in the initial year, then the NOI of each future year plus the sales proceeds after the sale.

Using the discounted cash flow model an investor or broker can calculate the discount rate or IRR for an investment. The IRR is the percentage earned on each dollar invested for each year it is invested in the property plus the sales proceeds. You can perform this calculation using the Hewlett Packard HP-10B11 calculator.

By completing a five year cash flow model adjusting for changes in income and expenses and then determining a future sales price based on anticipated CAP rates an investor can perform the IRR calculation to see how the investment may perform. You can take it one step further and reinvest the annual profits in a money market account further increasing the annual returns, then calculate your IRR rate and you will have really maximized your investment dollars.

After you sell the property by completing a tax deferred exchange, reinvest all of your dollars and do it again. Come retirement time you will have beat the returns most people are getting in their 401K. Jay Amoruso is a broker at Re/Max Precision Realty, Newington Conn.

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