Understanding Cash Flow Financials

Owning cash flow properties is really owning a simple business without having to manage the day-to-day operations. And like any business, the owner must still understand the numbers in order to ensure that the investment is performing well, and know what corrective action to take if it is not.

Following is an example taken from one of our actual properties to illustrate how to financially analyze a property. It was a single family residence with a sale price of $89,900. The analysis that follows Table 3 refers to the line numbers in the tables.

GOLIATH Table 1

Line	**Property & Loan Assumptions (Single Family Residence)**		
1	Property Purchase Price	$89900	
2	Down Payment 20%	$17,980	
3	Loan Term (Years)	30	
4	Interest Rate (Fixed)	4.75%	
5	Closing Costs	$3,000	
6	Gross Monthly Rent	$1,200	
7	Vacancy Rate	5%	

GOLIATH Table 2

Line	**PRO FORMA INCOME STATEMENT & CASH FLOW ($, ANNUAL)**		
	Income:		
8	**Gross Scheduled Income (GSI)**		**$14,400**
9	Less Vacancy Amount -10%	(-1440)	
10	**Gross Operating Income (GOI)**		**$13,680**
	Annual Operating Expenses		
11	Property Management -10%	(-1440)	
12	Property Tax (actual)	(-957)	
13	Insurance (actual)	(-409)	
14	Repairs and Maintenance -10%	(-1400)	
15	Landscaping/Utilities/Other		
16	**Total Operating Expenses**		**-4,206**
17	**Net Operating Income (NOI)**		**$9,474**
18	Less Debt Service (PMI included)	(-5,627.52)	
19	**Before-Tax Cash Flow (BTCF)**		**$3,846.48**

GOLIATH Table 3			
	Key Operating Ratios		
Line			
20	Capitalization Rate	10.5%	
21	Cash-on-Cash ROI	18.86%	
22	Gross Rent Multiplier	6.24	
23	Net Income Multiplier	9.4	
24	Debt Coverage Ratio	1.68	
25	Expense Ratio	30%	

Explanation & Analysis

Line 2 - In this example, the down payment was 20%; 10% or 25% down is common. Many investors pay 100% cash (0% down) in order to maximize cash flow.
Line 3 - The mortgage terms are most commonly 30 years or 15 years. Shorter terms result in faster equity buildup and lower interest expenses, but reduce cash flow due to higher monthly mortgage payments.
Line 4 – Interest rates on investment properties, especially with smaller loan amounts, are typically higher than owner-occupied mortgage rates ranging from 5.5-8% and will vary with credit score and the size of the down payment.
Line 5 – Closing costs vary with the size of the transaction. They are much lower for all-cash buyers.
Line 7 – Vacancy rate is the actual (or in this case, the projected) number of days the property is vacant and not collecting rents divided by the number of days in a year, 365. In most healthy rental markets, this rate ranges from 5-12%; 7-8% is average. It is one of the most important factors for an investor to manage. A good property manager who seeks long-term tenants and a well-maintained property will minimize the vacancy rate. Las Vegas has a large proportion of renters in its population, which means demand for rental property is quite high, so vacancy rates tend to stay low.
Line 8 – Gross scheduled income (GSI) is the annualized sum of all of the monthly rents possible on the property. It excludes allowance for vacancy.
Line 9 – The vacancy expense is the GSI (Line 8) times the vacancy rate (Line 7).
Line 10 – The gross operating income (GOI) is the GSI less the vacancy amount. If there is “other income” associated with the property (e.g. vending machine receipts, washing machine fees), it would be added into the GOI.
Line 11 – The property management expense is normally 7 – 12% of the GOI. Typically the higher the GOI, the lower the property management rate. This rate tends to vary by local market. In Las Vegas, NV, 10% is a typical number, as in this example.
Line 12 – Property tax varies by local market. Some states and municipalities have much higher tax rates than others.
Line 13 – Landlord or fire insurance rates vary primarily by region, proximity to potential natural disaster risks (flood, wind, earthquake, etc.), the amount and type of coverage selected, and by insurance carrier.
Line 14 – Repairs and maintenance are important to consider in purchasing a property. On average,

newly renovated properties should experience much lower costs in the early years after renovation, as in this example. Deferred maintenance will always be a cost, as over time the appliances, carpeting, roof, and similar items will wear out and need replacing, just as in any home. Ensuring that the property manager performs regular preventive and corrective maintenance will help control costs. Finding and keeping good tenants who have pride in their home is key.
Line 15 – Some multi-unit properties may not have all of the utilities metered separately, or the landlord may prefer to handle the landscaping himself. In this case the landlord must pay for these bills and will charge higher rent to cover the estimated increased costs.
Line 16 – The total operating expenses are the sum of the operating expense lines.
Line 17 – Net operating income (NOI) is the GOI (Line 10) minus the operating expenses (Line 16), and represents the profit that the property generates before servicing the debt (paying the mortgage.)
Line 18 - Debt service is the monthly mortgage payment (principal and interest) times 12 months. Remember that as principal gets paid, the debt on the property is reduced each month, so equity is built up over time. PMI is included in the debt service for the first 2 years if there is less than 20% equity.
Line 19 – Before-tax cash flow (BTCF) is the NOI (Line 17) less the debt service (line 18). If the BTCF is a positive number, the property is said to have positive cash flow.
Line 20 – The capitalization rate, most commonly called the "cap rate", is the NOI (Line 17) divided by the purchase price of the property (Line 1) expressed as a percentage. It is one of the most important yardsticks in judging the profitability of a property. The higher the cap rate is, the more profitable the property. An all-cash buyer gets a return on investment equal to the cap rate of the property (excluding closing costs.) Average cap rates vary widely throughout the nation, with lower cap rates predominating in areas with higher housing prices, such as in California. It is important to measure cap rate after including all the expenses in your NOI (as we do) many people fail to include vacancy, maintenance and property management fees and wind up showing an inflated cap rate that doesn't represent reality.
Line 21 – Cash-on-cash return on investment (ROI) is the BTCF (line 19) divided by the sum of all of the out-of-pocket acquisition costs. In this example, the out-of-pocket acquisition costs are the property down payment (Line 2 times Line 1) plus the closing costs (Line 5).
Line 22 – Gross rent multiplier (GRM) is the purchase price of the property (Line 1) divided by the GSI (Line 8). The lower this number, the better the cash flow potential. As a rule of thumb, in most markets a GRM below 8 ought to generate positive cash flow.
Line 23 – Net income multiplier (NIM) is the purchase price of the property (Line 1) divided by the NOI (Line 17). The lower the NIM, the better.
Line 24 – The debt coverage ratio (DCR) is the NOI (Line 17) divided by the debt service (Line 18). If the DCR is greater than 1.0, it means the property is generating positive cash flow, i.e. the property generates more operating income than it costs to service the debt. A DCR below 1.0 means the property is generating negative cash flow. Some banks, notably those lending on multi-unit properties, will not make a mortgage loan unless the DCR is above 1.1 or 1.2. The higher the DCR, the better.
Line 25 – The expense ratio is the total operating expense (Line 16) divided by the GOI (Line 10) expressed as a percentage. Usually numbers below 30% are considered good.

None of the foregoing analysis speaks to the after-tax benefits of investing in properties such as the one described in the example above, as these benefits vary widely depending on one's individual circumstances. The after-tax returns on cash flow properties can be phenomenal compared to many other investment vehicles (e.g. stocks, bonds and REITs). This is mainly because of the long-term capital gains treatment of properties held for investment by more than one year and the benefits of depreciation. Investors are encouraged to contact their tax advisor for more details concerning their individual circumstances.