<u>Gauges of Investment Returns in the World of Real Estate</u>

In the previous chapter we established the importance of pursuing relationships with people who can influence your thinking in positive way. As part of this, we set out to identify some of the lingo of a traditional lender. We started there, because traditional lenders will likely be of most use to you at the very beginning of your career as a real estate entrepreneur.

The piece of philosophy I need to stress at this time is that just because you are able to do something, doesn't necessarily mean that you should; just the fact that you can do it, doesn't mean it's good for you. As such, even though you are now able to speak intelligently to a person who can make financing for that investment house or a small multiplex attainable to you, it is important that you know how to identify the <u>right kind of investment</u> before you pull the trigger!

In this chapter I'll be discussing the metrics of real estate investment return – the type of things that need to be taken into consideration as part of your analysis. Incidentally, the language presented in this chapter is not only the domain of investing; it is also the language of commercial lending. A lot of the metrics discussed here will be used by your commercial lender when considering your proposal. So, pay attention!

I need to make it very clear that while an ability to understand these metrics and their application is crucial, it is only useful within the context of your knowledge of the overall market you are operating in. For example, having analyzed an investment opportunity to determine that it is capable of producing returns consistent with a 7% CAP Rate, in order to know whether that's good, bad, or mediocre it is necessary to know what CAP Rates other investors are achieving. If other investors are achieving 5%, then this deal is good, but if the going CAP rate is 10%, then this deal falls short. Thus, any transaction-specific analysis should be anchored by an in-depth knowledge of your market.

<u>Yield</u>

Yield is most easily thought of as the gross revenue, which in the world of real estate is the sum of all rental and other income attributable to a building. For example, if each unit in a 4-plex rents for $500 per month, then monthly yield is $2,000, while the annual yield is $24,000. Yield represented as a percentage is calculated with the following formula:

$$\text{Yield} = \frac{\text{Gross Revenue}}{\text{Price (Value)}}$$

Thus, if you pay $130,000 for a 4-plex which generates an Annual Gross Revenue (Annual Yield) of $24,000, then it can be said that your investment yields 18.5%:

$$\text{Yield} = \frac{\$24{,}000}{\$130{,}000}$$

Yield, as a measurement of the health of a real estate investment, is rather limited by the fact that it does not take into account the expense structure of the building. As a result, it is possible to have two buildings with an identical yield produce substantially different NOI (Net Operating Income) based on the reality that one costs a lot more to operate and maintain than the other. As such, the only useful application of this metric is with respect to determining whether the rents in a particular building appear to be in-line with other buildings of similar nature and location.

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