

# "How Do You Figure?!"



by Randy Lee

When I read about a property that only produces \$850 per month in rental income, that is for sale in an area that experiences very little appreciation...and they are asking \$115,000 - I want call and ask "How do you figure?!"

Every seller generally has an inflated opinion of what their property is worth. Buying into that opinion can be a costly mistake. Unfortunately it is an error that inexperienced investors make too often. Remember the old adage, "You make your money when you buy it, not when you sell it".

As an investor, it is essential that your buying decision is based upon facts and predictable formulas. Emotionally charged opinions and speculative predictions are prime ingredients for failure, foreclosure and bankruptcy.

As an investor myself, as well as a licensed agent who represents investors from across the US and Canada, I have learned some things the hard way too. However, through experience, education and insights of partners and clients, I have learned methods that help us avoid some of those pitfalls.

It is essential that we, as investors, are equipped with tools to calculate the value of a property to us. The same property can hold a different value to different investors depending upon their methodology. We have developed formulas and models that allow us to analyze potential investments efficiently, effectively and without interference of emotion. In other words, *we don't fall in love with the deal*.

A simple formula that allows us to determine a workable purchase price for rental property is:  $\{\text{Monthly Income} \times 12\} \times 70\% / 10\% = \text{Logical Purchase Price}$  (all things being equal). So using this formula, the example property above, with an \$850 monthly rental, our logical buying price would be \$71,400.

The reason we multiply rents by seventy percent is to calculate a likely net operating income (NOI). So, in this formula, we are assuming that the cost for taxes, insurance, vacancy, maintenance, management, etc. will cost thirty percent of our gross revenue. In some instances, we may use a lesser factor to determine NOI if we believe our expenses will be greater than thirty percent of gross revenue. Higher vacancy rates and likely increased maintenance costs are two examples of factors that significantly increase our expenses.

The ten percent factor is our desired CAP rate. This represents the rate of return we hope to make, not including appreciation. So, by dividing our projected NOI by our desired CAP rate, we arrive at a price that we would be willing to pay for the property; *providing there are no surprises*.

The less appealing the neighborhood, the higher that number will be. In contrast, if a property is located in an area where factors tell us the likelihood of appreciation is greater, we may opt to divide into a lower CAP rate. In other words, we will be willing to earn less short term if there is measurable promise for long term appreciation. The key word in that sentence is "measurable".

Measuring the likelihood of appreciation on a piece of real estate is speculative business. History is usually the best predictor. However, as valuable as comparable sales histories can be - they certainly can not be your only consideration.

Local knowledge of trends and changes are key. For example, the projected growth of Huntsville due to the military base realignment (BRAC) or the possibilities presented in Chattanooga should Toyota select the city for its next factory site, are situations that can effect future values. As exciting as the opportunity presented by these factors may be; it is still important for the investor to be cautious.

Understanding which areas will be most effected by positive *and negative* factors such as these, takes deeper research than just reading the newspaper. Fortunately, in today's age of technology, information is only a few mouse-clicks away. It is logical to believe that an area will experience some of the same growing pains and opportunities experienced by other areas when they underwent similar changes. Using facts and formulas will enable you to negotiate with power, when the seller asks you, "How do you figure?!"

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