FINANCIAL ANALYSIS IN REAL ESTATE

Host: Zack Childress

So, the big question is this, how do aspiring real estate investors like us escape from the rat race and build real wealth and freedom without access to millions of dollars in investment capital and start to live the life that we know we deserve? This is the question and this podcast will give you the answer. My name is Zack Childress and welcome to Real Estate Investing Talk Show.

All right, well listen, it's a pleasure that you guys are all here with me. We've got so much to talk about today and I'm going to help you a little bit get things organized when it comes to, you know, what are all these acronyms, right? Like, what's an LTV, what's an ARV, what's CAP rate, what's an NOI? You know, how do we understand cashflow analysis and what's the power of leverage, right? What is the power of leverage? So those are some of the things we're going to be talking about today. And um, I think it's important that you get your head around the concept of how we make money in real estate, right? Um, because if not, and you don't understand these terms when people use them and you don't know what they're talking about, they're going to do this: (crazy laughter)

Yeah. I'm feeling kind of funny today. So thinking about this, one of the big things I want you to understand is really start to understand like what is a CAP rate, what is an NOI? What is an ARV? What are these terms and what are they needed for in your real estate business? Okay. We call it financial analysis because that's the proper way of saying it, right? It's, it's understanding the terms in which we use math or equations or research to figure out the financial analysis on a property. And so when we look at it, let's just, let's just talk about some rental properties real quick. So when you're looking at rental properties, there's a few key factors you've got to figure out, right? Factor number one is, is what in the world is my money gonna do me if I move into that deal, that's the ultimate number we're trying to get to.

And that is called a COCR. Write that down. What is the COCR? COCR is cash on cash return, meaning what is the return on the money that I'm using of my money into that deal? Not borrowed money, not leveraged money, not private money, not bank money, but what is my money making me? Which ultimately is the only thing that matters. Really, t's the only thing that matters.

Look at here. I forgot about this check sitting right here. I got $2,500 check sitting on the desk here. How about that? I need to put that in my wallet? So it's, what is my money making me? Now you might say, okay, Zack, I get cash on cash return. I've been to your Two Day Immersion. I know it like the back of my hand. I understand that's the number I'm getting to, but when I'm just looking at properties online that are rental properties, let's say it's an eight unit or 10 unit at 20 years in an apartment complex, um, let's say it's a mobile home park, whatever the case may be. Well, you've got to take some assumptions upfront, right? And this is the only time I ever used CAP rate. This is it. You guys ready? You don't want me to give CAP rate, right? This is the only time I ever used CAP rate. I know this is a big moment, right? Because I tell you guys never go off a CAP rate and trust me, I don't buy off a CAP rate, but I will use the CAP rate to, uh, get to the initiation or the initial numbers that I need to base a cash on cash return off of.

So when I'm looking at the property, a lot of times the seller and the broker will tell you what the CAP rate is on it. So I'd take the CAP rate. Let's just say we're looking at a property I don't know, that has a nine cap. And let's say they want, I don't know, a million dollars for the property. A million dollars times nine percent means that the net operating income is $90,000. That is why we use CAP rate. You take, hold on a second, that's wrong. Divided by nine percent. Okay, 11... it's a T chart. My brain is going blank right now. NOI, CAP purchase. I don't know if you guys can see that, but that's what you should write on your paper right now. Hopefully you guys can see that.

Write a T chart, put NOI on the top, put CAP on one side and purchase on the other side. Okay? And the reason that is is because you take CAP rate times purchase price, which is $90,000, so nine percent times a million is what they want for the property. It's $90,000. So that gives you the top formula right, NOI. Okay? So the NOI on that building, if it's a million dollars a no, you guys can't really see that can you, is $90,000. So now that I know what the NOI is, so what is the NOI? Net operating income. That is not a true number.

Please listen to me. Oh, he zoomed in on that real quick, didn't you? Um, that's not a true number. Okay. It's not a true number, it is an initiation or it's an an initial number to get you started. But don't be fooled by the NOI. This is why I tell people don't use the CAP rate. Okay? Now let's get clear on that. Alright? But I use it to get to cash on cash when I don't have the financials when I don't have the P and L's and the and I don't have the rent rolls and all of that stuff. Okay? So here's why. Because if I can get to the NOI right, which is $90,000 on this deal than I can now assume what is left to take out of that? The debt services. So on a million dollars, the bank will probably give me 800,000 of that money.

Okay? Which means I got to come to the table with $200,000. So now I have to take an assumption of what my debt services is going to be on 800,000. So I'm going to take 800,000 point zero zero six times 12. That gives me $57,000. Okay? So we take 90,000, which is the NOI minus the debt services, taxes and insurance. That gives me $33,000 of true cashflow. That's how I run number so fast. Okay. Because I'm looking on loopnet or wherever and if I see a deal, they're usually going to tell me the CAP and I can use that to back down to the NOI. Then take an assumption with the loan's going to be so that I can take out debt services, which gives me a a $33,000 true cash on that deal cashflow. Now we can only assume that the NOI at 91,000 is based on their numbers and on how effectively are they running that property.

That NOI could be higher or it could be lower depending on how old the building is, how new the building is. But that's just the initial look at. So remember my first thing on rental properties is I want to know what the cash on cash with the cash on cash return is. So now I know if I'm going to go get a loan, I got to put 200,000 into that. But what else do I gotta do I got to inspect the property? I got closing fees. So let's just say I got 225,000. So now I know that the estimated true cash on this deal is $33,000. I divide that by 225. That gives me a 14.6% cash on cash return now. And you understand the difference, right? Like the CAP on this building was nine percent, but my cash on cash is almost 15 percent.

Okay? That's why I want you to understand you're not making nine percent on your money. When you look at the CAP rate, you're not making nine percent on your money. That's the capitalization rate of the building itself. Meaning that's the rate in which it's growing or which it's being able to be assessed at. You want to know on your money. That's why we use CAP NOI to get to cash on cash. And it's important that you understand that model.

Now, would I do the deal at 15 percent CAP or cash on cash, it just depends. Um, I can tell you right now, I would never do a C class building at a 15 percent cash on cash return. Never, never. I'll do 25, 30, 35 percent on a C class. On a B class, I'd probably consider a 15, 15 to 20. And the reason being is because a B class building has potential equity. It has potential growth that it's not as, you know, it doesn't have as much deferred maintenance. It's not, you know, it's not the C building, right? It's the B building.

But remember when you're starting off on building cash in your pocket, you got to start somewhere where you can make more money faster. And that's the c class building types. That's the ones that, you know, you're going to get that, um, uh, that aren't in the best part, but it's not a war zone. Let's be clear, that's d class, but it's like, right in between, you know, it's like that, that, that, that next level, right? It's that next level. So, um, and I own a ton of C class buildings, but will I take a 15 to 20, yeah, on a B class, would I take an eight to 15 on an A class? Yes, I absolutely would because you're just not going to get, I mean, in A class building, getting over 15 percent. I mean getting 15 percent on an A class building would be insane.

But it's all about structuring of the deal because remember, I'm not doing CAP, I'm doing cash on cash, so less money if I can work it or I'm getting less money in the deal, then I'm going to do that. Um, but that's when we're talking about cash on cash, that's how we have to work backwards. We have to go back and look at the CAP to determine the purchase price, to determine the NOI, to then take out debt services to get to cash on cash. Now it's important to understand it because NOI, net operating income, that's what they expected to be. CAP rate is capitalization rate, right? Debt services is basically the mortgage payment that gets you to cash on cash return.

Now, that's what gets me in the deal, but once I'm in the deal, I'm asking for things, right? I'm asking for two years of financials. I'm asking for rent rolls. I'm asking for financials so that I can validate that information. Um, uh, and if you've got somebody that's saying, oh my, here's the reality, when you're looking at deals and you're running expenses, it's normal for a, a building to run at a 45 to 55, even 60 percent expense factor, right? Um, when you're looking at a building and they're telling you, oh, well, my ability only runs at 30 percent or only 40 percent, I can tell you right now, somebody better hit the bs meter because there's, that's not, that's not true, man. The only way that's true is if there's a lot of deferred maintenance that they're pushing off, if they are self-managing it themselves, you know, there's a lot of things that could offset that.

But, you know, the last thing you want to do is keep pushing deferred maintenance out. The other factor is, is do they even have a reserve account? Like, there's so many things, we're not here talking about commercial, but I want to help you with your financial literacy a little bit better. So that when you're looking at the topic called cashflow analysis, that's really what that is. Now, let's say I'm looking at a fourplex. It's not based on a CAP rate. I'm going to do the same thing, right? I'm going to get to the NOI. I'm going to take gross rents. They call it a GR gross rents. I'm going to minus my expenses first, second and third tier expenses to get to an NOI. And if you do it correctly, your first year is going to have your debt services in it.

So I'll get to a true NOI and then I'm going to just do the same thing, divide that by total cash invested, gives me my cash on cash return. And so when you're running that angle, you now understand where you are on the deal. And let me just be clear on this. There's like a, there's really a three question test you can always ask yourself like, you guys that know me, know that I like these three-question test. Um, if you've been to my bus tour, I tell you there's three questions you've got to always ask before you buy a deal:

Can I buy it at a price point that if I needed to wholesale and I could? Yes, check.

Can I buy it, fix it up and sell it retail? Well, there's a lot of factors around that, right? Like is there enough profit in there? Is the budget correct? Is it in a market that's going to sell? Is there a clustering zone? Is that a yes? Yes. Check.

Can I buy it and if it doesn't sell for some reason, can I buy it low enough that ran it out and make cash flow on it? Check.

That's my three-question test on a rehab and I have to have two of them before I say yes to the whole deal. On rental type properties, I have a similar three question test. Number one is: what's the cash on cash return? Number one, what's the cash on cash return and does that cash on cash return meet my standards, okay? Does it meet my standards? Question number two is: is it even worth my time and energy? So what does that mean? Look, the cash on cash return could be 67 percent. Let's just say that.

That would be insane, right? Like wow, that's what I want, but it might only make me $2,000 a year. Well, is it, is it worth my time for $2,000 a year? Those are the questions I've got asked myself. And then question number three is: it a headache or not a headache? You with me? So question one, what's the cash on cash return and does it meet my standards? Question number two is, is it worth my time, right? Is the money that's going to come off of this worth my time to deal with it? And question number three is isn't going to be a headache. So what would make it a headache? Well, it's in an area that is just absolutely a nuisance to try to keep rented. Right. It is the type of property that has high turnovers.

It's the type of property that has a ton of deferred maintenance and I have to constantly be working on things; that's a headache. I don't want it, right? So if the cash on cash is good and the worth my time is good, well then okay, the headache.... I might be able to deal with the headache. You follow me? But let's say the cash on cash is good and the money's not so good. So you know what I mean? I don't know if the money is worth my time, but it's not a headache, meaning that I don't have to do a lot with it. Like I never have to go to it, I never have to worry about it. I don't have to do nothing with it. I just go put my money in and, well, then okay, I might take it. My point is, as I'm looking for two yeses out of those three questions as well, same in the Rehab Business, right? A three-question test before I take a rehab on, a three-question test before I take a rental property on. So you have to get them three questions out there. Alright, so listen guy. So let's now let's talk about some other stuff. So I'm going to move you into ARV and LTV and why they're different, and why you need to know they're different. Okay. Especially for the new people,

Be very clear that ARV is really an assumption. That's what it is. It's an educated guess on the assumption of what that property could be worth if things were done to it. Okay? So we all know what assumptions do; they get us in a lot of trouble if we're not very skilled at it and we're not fast at the deal itself because an ARV is after repaired value. So let's talk about that. Well, somebody will say, well no, I mean that's what other houses are selling for. So this house should sell for that. Well, yeah, it should, but it's an assumption and there's a lot of things that could alter that. The market could tank all of a sudden, you could have taken too long to do the deal, now prices are different. Foreclosures could all of a sudden popped up and you know, you follow me, like there's assumptions.

That's why we say there's risk in real estates, especially when you're slow. And that's why we say don't do big rehabs when you're first starting out because it takes too long. So the assumption of the ARV that you thought was there, now six months later, you're putting your property on the market, It could be completely different now. It could be good, it could be bad. I'll give you that because right now in our market, yeah, I mean if you wait six months, it's going to be worth more. But that's an assumption, right? So ARV is based on an educated guess on what it's going to be worth in the future. The best way to really get that idea of what it will be worth in the future is to look at solds obviously, like what's selling now, and that's the assumption that I think this property will sell for when I'm done.

You could get an appraiser to come in and the appraiser can do what's called a future value or an after repaired value. Or most appraisers go on what's known as current value state. Okay? They'll say, well, here's the current value of the property, right? And so you just gotta make sure you're clear when you're working with an appraisal, and what type of value you're trying to receive. Like I need its' current value, or I need to know what it could be worth fixed up. So then they can, instead of just looking at comparables on that property in its' state, they could only isolate properties that have been fixed up in that market and say, well, here's what the assumption or the, here's what we, uh, we think this property will be worth when you fix it up. There're two different values because, and as estate your property could be worth 200,000.

A ARV after repaired value property could be worth 300,000. Right? And so where you could go wrong, or homeowners do go wrong is they go look at properties that are selling in the neighborhood for $300,000. And they go, oh, well my property is worth $300,000. Well, no, it's not. The as is is only 200. Now if you want to put in Mr. Sadler, $40,000, then yes, you could get 300,000 depending on how quickly you get it done and get it on the market because the market could shift, it could go up, it could go down. It's really, you know, an assumption. And that's why we always say it's an assumption, right? We're assuming that the market is going to stay where it's at right now when we get to the time for ourselves. The challenge with that is you would be naive to think that the market is going to stay still because it's a commodity.

Real estate is a very high demand commodity right now, so we know that when commodities are in high demand, they go up, but what we also know is that when commodities are not in high demand, they go down. Okay, so you just got to keep that in mind when you're looking at it. And that takes us to LTV. LTV is loan to value and that's what banks go off of. That's basically what the contract is. So when you go into a contract with somebody for $200,000, well guess what? That's the loan to value because the banks see it as that's the value of that property and it's as is state and the reason that they say that is because they say that the value of something is what someone will pay for it. Not the future value because banks aren't in the assumption business, unless you're doing new construction with them or something like that. They'll play in that world a little bit with you.

But most banks don't like that type of risk. And so, when you go to a bank and you're going to buy a house and you have a contract for $200,000, that's called an LTV: loan to the value. The value is stated at what someone is willing to pay for the property in its' as is state. And so that's what they base it off of. Now you have asset-based lenders and hard money lenders that understand ARV and future value. They understand that and they're willing to take the risk with you because of the market condition. And that's why they charge more interest and more points because there again, it's a risk. They know it's a higher risk whereas the banks, they're not going to play in that risk.

Right? And that's why they go off of LTV, because they say, hey look, I get it, if you fix it up it's worth 300,000, but you've only agreed to pay $200. So therefore, the value as is is 200,000 and that's what we'll loan you on. So they're in the wind, if you go in and fix it up, because now they've loaned you 80 percent of a $200,000 dollar value that you turned into a $300,000 value. So they've loaned you $160,000 on a $300,000 house, which means their in risk and they're in it only about 50 percent of value at that point. Okay?

So that's why they play in that world to control their risk factors. So, so you just got to understand when you're hearing that terminology, you need to know what LTV is. You need to understand what they mean by value and you need to understand what after repaired value, and is future value. And, and there's a lot of little nuances in that and swimming down the river and you can go a lot of different ways, when it comes to that.

So now the last thing I'm going to talk to you guys today about is leverage and how important leverage is in your business. You need to get real clear that leverage is the pivotal point of a business and its growth. There's only so much you can bring to the table, okay? There's only so much. After that you have to start leveraging. This is why I say leverage your way to millions. Leverage your way to millions because it's the ideal aspect of being clear on the more money I borrow, the more cashflow I can make, the more assets I own that become more valuable over time so I can leverage a million dollars of borrowed money and I can make in a good time about $200,000 off of that. Okay? If I'm leveraging that money correctly, let's just say that you're leveraging a million dollars at a 20 percent rate of return. Okay?

So let's say, well, let me back up a minute. Let's say that you're holding a million dollars' worth of real estate. Okay? The value is a million dollars. You had to get a loan for 80 percent of that, so you had to get a loan for $800,000 to leverage against a million dollars' worth of real estate. Okay, now if you've got a million dollars' worth of real estate and that million dollars' worth of real estate is making you, I don't know, let's just say 30 percent on your money. So what, and this is why I want you to see how big that number is, but how much bigger you need the number to be. Okay? So I go get a million dollars' worth of real estate. I'm going to leverage the bank at 80 percent. So they're going to loan me $800,000 for that million dollars' worth of real estate. I got to come in with 20 percent, which is $200,000. If I'm making 30 percent return cash on cash then on my $200,000, I'm making what?

$60,000 a year off of a million dollars' worth of real estate. Now starting to see the picture. That's at a 30 percent rate of return. So you've got to start, you need to be leveraging $10,000,000. Do you understand? If you're making 30 percent on your 20 percent injected into a leverage loan and at a million you're making 60 at 10 million, you're making $600,000 a year, so this is why I'm always saying leverage, leverage, leverage. Don't be afraid to leverage a million dollars' worth of real estate. Don't be afraid to leverage $10,000,000 worth of real estate. Don't be afraid of that because that's how you grow. That's how you start to multiply your capital. You start to create every three years, you're doubling your money every three years, you're doubling your money and that's how you build more longevity and that's how you build wealth. When you start to understand the power of leverage and using these banks, and if you're like, well Zach, I can't use a bank right now, well then you need to get your shit together, man.

Excuse my language, but you need to get your credit fixed. You need to get some type of stable job to start making some money while you build your real estate business. Okay? I mean it makes me sick when people walk up to me and they're like, "Zach, my credits 400, I ain't got no job, but I need to do a deal". Okay, well then wholesale, wholesale, wholesale, wholesale, wholesale, but wholesale is just another job. You need to be wholesaling and building well, so my advice to you as a coach is go get a job, get a job so you can make some money. Work on your credit wholesale while you're doing that so that you can get stable enough to start buying rental properties from a bank. That's wealth. Okay? If you're saying to me, well, I'm just going to pay cash for everything, well then you're a... I'm not going to get on you guys too much today.

I want to be able to pay cash for everything and not have to worry.

Nooooooo, no. You need to leverage. The worst thing an investor can do is pay cash for real estate. That's the worst thing you can do. You need to leverage everything. If you're going to spend cash, you spend cash on your business. You spend cash on educating yourself. You spend cash on growing your knowledge base. You spend cash on you, not your investments. That's what leverage is for, you understand? That's why we leverage. Smart investors understand leverage to the 'T'. They know I've got $100,000 I'm going to use part of that for leveraging to get more deals and I'm going to use another part of that to educate myself so that I can grow and I can be wiser and more intelligent, but see, some of you guys think, Oh, I'm sitting on $200,000.

How do I go spend that on real estate? Well, that's because that's what your Mama and Papa taught years ago and look how far it got them. Okay, you need to back up a minute and you need to understand the power of leverage and how to take the money that you do have and how to dissect that money and start spending it wisely to leverage as much. Here's what I want you to just do the math. If I was making 30 percent on a $200,000 investment into a million-dollar deal, do you understand what that really looks like? That's like, what? That's $60,000 a year. Okay. Offer that property. So let's get clear on that. So the debt service on that is going to be, we just did the math earlier, it was like $50,000 the debt service. Okay? So let's remove the debt service. So now you're up to $110,000. Okay? Because you're going to pay cash for it. You go out, you buy a million-dollar building for a million dollars, you're making $110,000 off that building. Jill, do the math, take 110,000 divided by a million. What do you got? It should be like 11 percent.

So would you rather have 11 percent on your money or 30 percent on your money? That's the message I need you to hear from me today. Okay? It's not about that you don't have the, If some of you don't have the money and you're like, yeah, I wish I had a million dollars. Well you got to go out and build it. You can't wish yourself rich. Okay? You got to get up off the couch and you gotta make it happen, but if he did have the million dollars, the worst thing you could ever do is take a million dollars in buy real estate with it.

The best thing you could ever do is go build a relationship with a bank, leverage their money and triple your return, triple your return. Take that million dollars and spread it out over multiple deals. Take a portion of it invested in yourself and your business, grow your business, grow your infrastructure, grow your knowledge base, grow who you are as an investor, and then leverage the rest of it out and you will be, and every three years that million dollars will be worth 3 million now. Listen to the math, that million in three years we'll be $3 million. That $3 million in three years will be, what? $6 million? That $6 million in three more years will be $12,000,000 over nine years.

Or we could go buy a million dollars' worth of real estate with a million dollars and make 11 percent and over nine years I wouldn't even have all my money back. Well, yeah, no I wouldn't. I'd have 99 percent of almost have $2,000,000 over nine years. Where the other route I would have 12 million. So do you want 2 million in nine years? Or do you want $12 Million and nine years. Do the math guys. Now, is there a point where you start paying everything off? Yeah, absolutely there is, but it's not until you've built everything to the point to where you say, look, if I paid everything off, heck I could live on a yacht and travel the world, but you're not there yet.

So you have to leverage that money and leverage it to the max. Okay? Leverage it to the max. So when you get to the point that you're making, I don't know, $200,000 a month if you buy it, pay everything off.

Okay? Then start paying everything off, panel off. Now you make it about $3 million a year. If you want to live on a yacht and travel the world, you're going to spend about 50 grand a month for the yacht, so you know you're good, you're good. Hit the water man.

Take the kids, get you a homeschool teacher. That's going to cost you another 50 grand to live on the boat with you. Now you're a 100 grand. Well now you're a $600, $700,000 a year. Then you gotta add in food and travel and you know all the excursions. You probably a million dollars out a year to live on a yacht and travel the world. So now that means your bank and 2 million a year in savings off of your investments. Now who's with me on that? Spend a million. Travel the world. Save $2 million every year. I couldn't save 2 million because I'd probably want to go reinvest it, but you know, that's just me. So.

Alright. Anyways, that's my pitch on leverage, guys. You gotta leverage. You got to leverage your way to millions, man. You've been listening to the real estate investing talk show, I'm Zach Childress and I'm on a mission to create 10,000 real estate bosses over the next year. Will you be one of them? Head over to my website, REI Success Academy.com/webclass, and register for my free web class, where you'll discover how to escape from the nine to five grind and become your own boss in real estate. See you there.