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There is truly a lot to be learned about investing in real estate from the game of Monopoly.

Why Invest in Real Estate (Part 3 of 3)
Evaluation Approaches

Someone once told me that real estate was a lot like the game of Monopoly. You buy all the land you can, work toward putting little green houses on your properties, until eventually, you can afford to trade in the little green houses for big red hotels. In the game of Monopoly, we all know which properties are more desirable than the others. The properties progressively get better as you move around the board. The better properties cost more to purchase, but they deliver a higher return on your investment over time as people land on your property. There is truly a lot to be learned about investing in real estate from the game of Monopoly.

In real life investing, however, you generally do not just purchase every deal you "land on." This is where the art and science of Investment Evaluation Approaches comes into play. There are several methods or approaches that can be used to measure the strength of a real estate deal in order to help determine if you have actually found a great deal. While every approach has its strengths and weaknesses, there are certainly some that are better than others. Knowing when and how to use them, apply them, and then understand what they are telling you, is part of the art in the science of "crunching the numbers" in the game of real estate investing. Like most things, the more you do it, the better you get.

As I mentioned for purposes of this article, there are quite a number of approaches. So, we are only going to look at a few of the more common ones.

CASH-ON-CASH RETURN

This approach is a quick way to get a sense for what type of return you are looking at receiving in the short term from your investment. Cash-on-cash simply compares the cash you bring to the deal at the beginning measured against the cash you will receive in the first year. It is a quick snapshot.

CAP RATE

The Cap Rate, which is short for "Capitalization Rate," is one of the more useful measures and one of the more commonly used metrics to value property. The Cap Rate is a measure of the relationship between the property's value and the Net Operating Income (NOI). If you know the NOI of a property, then you can apply the current market Cap Rate for that type of property and determine the likely price of the property. For instance, if a property has an NOI of $45,000/year and you know that similar properties have been selling for around a 7% cap, then you can divide $45,000 by 7% (.07) and the results, in this case, would be a value of about $642,857.

PRESENT VALUE

Present Value (PV) relates to the Time Value of Money (TVM). In simple terms, this is the concept that we all intuitively understand – that a dollar today is worth more than a dollar sometime in the distant future. If you can grasp the concept of compounded interest as it relates to a checking account, the Time Value of Money concept is just done in reverse. As it relates to real estate, it asks the question, What is this investment really worth in today's dollars as it compares to other potential opportunities I have available? This opportunity cost is what is called the "discount rate" or sometimes referred to as the investor's required rate of return. The Present Value of a real estate investment is determined by running a discounted cash flow analysis on all the future streams of positive cash flow and usually evaluated on a 3- to 10-year time horizon. Without getting too far into the weeds for purposes of this article, certain assumptions are made, one of which is the estimated sales price, say for instance, at the end of five years. Each stream of cash flow, usually broken down by year, is then discounted back to the present, with the final year combining the cash flow plus the net sales proceeds. Still tracking with me? If not, don't worry, it does get a little technical. Although this method is one of the more technical and time consuming to compute, it is certainly a preferred one for serious investors.

Of course, just crunching the numbers is only part of the process of investment analysis. You will also want to perform a thorough evaluation of the property and take a look at the financial reports, expense ratios, leases, demographics, etc. Performing an in-depth due diligence process will keep you safe and happy. Good luck and happy investing.