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No shortcuts in real estate valuation

I was recently contacted by a client whom I consider to be quite a savvy commercial real estate investor. I have represented her group in dozens of multifamily residential properties over the years, from four- or five-unit value-added plays to 100-plus-unit long-term investments.

This client has continually impressed me with her ability to target a good property, foresee an end-use that others may not see, close on the property and produce profits that often exceed her or her investor's expectations.

In most circumstances, I find myself learning from her just as much as, I hope, she is learning from me. My firm's slogan is "Right there with you," and I truly believe that is the case with this investor client as well as with most of my commercial real estate clients.

I think of myself as part of a team working together to lead clients toward success, and I value these relationships.

During this recent call, however, I realized that my savvy client was venturing into a different commercial real estate market than what was typical for her. Rather than a large apartment building acquisition, she was eyeing a single-tenant, triple-net-lease building for purposes of fulfilling a "1031 exchange" and the perceived returns that would result, under Section 1031 of the Internal Revenue Code.

We discussed the property and all the aspects involved with such an acquisition, including due diligence needs, title issues, entitlement and feasibility concerns and — of course — the financial analysis she had conducted to date. This is where the two of us took a temporary departure in agreement, and this is what inspired me to write this article.

Up until this point, my client had relied on simple calculations to confirm her current real estate valuations. I would call these back-of-the-napkin calculations, which can be useful in certain circumstances and certainly valuable for a quick evaluation of certain types of properties.

But they need to be used with caution, absent a more in-depth analysis and careful contemplation. For the client's previous multifamily transactions, these shortcuts actually proved to be good measures for initially evaluating properties — only to be later confirmed and refined by a carefully discounted cash flow analysis.

Some of these shortcuts, as I understand them:

The 50 percent rule

This is often considered a quick analysis for determining potential cash flow from a property. It goes something like this: Take your gross rents and subtract 50 percent to get the estimated net operating income, then subtract your debt service. The result is your cash flow.

The 1 percent rule

For years, multifamily investors have used this rule, which simply states that the monthly rental income for a property should be roughly 1 percent of the price that the inventory pays for the property.

Cash-on-cash return

This is also called the equity dividend rate and is often considered the gold standard for many investors. It is the rate of return you receive on the money you personally invest in the deal. Specifically, it's the ratio between the property's cash flow within a particular year (which, to highlight the point of this article, depends on how you calculate cash flow) and the amount of the initial capital investment, expressed as a percentage.

Cap rate

Including capitalization rates on my list of shortcuts may seem a bit controversial to the seasoned real estate investor. However, as I've mentioned in previous columns, unless you properly calculate the property's net operating income and have a good sense for prevailing cap rates in the targeted geographical area, it can be deceiving.

Without further financial analysis, it may also be misleading.

So, how to bring all this back to the call with my multifamily developer client wanting to invest in a substantial triple-net, single-tenant building? The obvious problem, which we confirmed through a more carefully discounted cash flow calculation, is that while the above shortcuts can sometimes be useful, they should never be used as a substitute for in-depth analysis.

For example, the so-called 50 percent rule cannot accurately predict the cash flow for my client's contemplated triple-net property acquisition. Why? Because the operating expenses for a triple-net, single-tenant building are monumentally different from those of a multifamily apartment building, regardless of size.

Furthermore, the 1 percent rule is equally invaluable when analyzing a property that may be located in an area with rocketing property values. Relying too heavily on some of these oversimplified calculations will only lead to potentially disappointing returns in the future.

There is absolutely nothing wrong with back-of-the-napkin projections. We all use them when conducting a site visit or determining quick evaluations for the viability of an investment property. However, a careful and calculated discounted cash flow analysis always allows the investor to establish a clearer outlook into the future — which is the whole point of investing in the first place, right?

THE REal DEAL

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