

## **Return on Investment**

An investment in real estate, or any other asset for that matter, can be characterized as the commitment of funds, capital, at the outset of an undertaking, with a series of benefits expected to follow over time. Those expected benefits are the return on the investment - in fact they are both the return "on" and "of" the investment.

Investments are made with surplus capital, both short and long term, for the purposes of economic gain and wealth building. An investment in one particular undertaking or asset as opposed to all others is made because the anticipation of economic gains, that series of benefits, from that particular investment has a value in excess of that available to the investor elsewhere, all equalizing factors considered.

Therefore, to make investments intelligently we must be able to measure the return on those investments, to value those returns, to compare the value of the return on one investment to another, and finally, to adjust for variances. Real estate as an investment is not so peculiar so as to defy rational analysis. Useful techniques need only be employed:

- 1.) To determine what the returns on the real estate investment are;
- 2.) To value those returns while allowing for variances in liquidity, timing and risk, and;
- 3.) To compare the value of the returns from one investment to those from another, all while keeping the playing field even.

Real estate investors invest for economic gain. They sell an investment for the very same reason. They invest in a particular property because the projected economic gain is in excess of that which may be available from another property or from another form of investment at the time the decision is made to invest. An investor sells a real estate investment because the anticipated gain from continuing to hold that property is less than that offered by some alternative investment opportunity for the proceeds of the sale.

To not sell a property when an opportunity presents itself, or to not liquidate an investment, is the same as buying that very property for the amount for which you could otherwise have sold it - - to not sell is to passively reinvest. What actions an investor takes, to buy, to sell, what to buy or sell, all seem to turn on the comparative analysis of the expected future economic events and benefits - - that series of expected benefits, earlier referred to, that lead to economic gain and wealth building. To sell real property requires the same intensity of investment analysis as buying real property.

What is the return on a real estate investment? - What are the components of that return? - How do you measure return? - What is an acceptable return in the absolute? - Shouldn't the timing of those returns and related investment risk be considered (risk of the loss of earning and/or capital)? There are many questions, and confusingly so, many more answers than questions.

The return on a real estate investment can best be defined in terms of its components:

- 1.) Periodic cash flow from operations;
- 2.) Any federal and state income tax benefits to the extent they exist, and they do exist, and;
- 3.) Appreciation realized through a capital event such as the refinancing or disposition of the asset.



These components are all received in the form of cash inflow, or cash outflow reduction as is often the case with tax benefits. These components of return on and of an investment should represent:

- 1.) A return of the original money invested - the return "of" the investment;
- 2.) Rent on that money for the time that it was used or invested;
- 3.) An allowance for the risk of economic loss assumed, whether from operations or market fluctuations, and;
- 4.) A margin for the inflation that may occur during the investment period.

The later three components are the return "on" the investment.

The return on an investment is typically measured in terms of the amount of the original investment - measured as a percent of the original investment yielding a "rate of return" on an annual basis. As a simple example: - \$500,000 invested; - \$50,000 earned per year as a return; - divide the little number by the big number,  $\$50,000/\$500,000 = .1$  or 10%; - annual rate of return is 10%.

There are various methods employed in the industry to measure this rate of return. No one method is particularly wrong. However, not all methods are applicable to a particular investment situation. Some methods truly yield a better reflection as to what the realities of the investment and the rate of return are, and some are better tools for purposes of comparing the return from one investment to another. What is important is that the investor knows:

- 1.) Which technique is being used;
- 2.) What assumptions are being made;
- 3.) That the calculations are accurate;
- 4.) The limitation of the approach to analysis employed;
- 5.) That allowances for varying levels of risk and the timing of the receipt of the returns were made, and;
- 6.) For comparison purposes, that the same technique was employed and that the same assumptions, adjusted as necessary, were applied to all properties compared -- apples to apples, oranges to oranges.

It is often the case that these criteria for an analysis of an investment and its return are not met. This most often is the case when more than one real estate broker or agent is reviewing properties with an investor and performing the analysis for that investor. In most cases, brokers employ excellent tools of analysis, but also in most cases, they differ from those of another broker. There is no particular industry standard, no generally accepted technique or software, with the exception of Argus, PlanEase and ProJect – all for the sophisticated analyst. And certainly, the assumptions made by one broker in reference to a particular property or approach, may be materially different from those made by another broker in reference to another property.

It may be a matter of the brokers simply having different real estate investment analysis software, or a matter of fundamentally distinct approaches to problem solving and analysis. When comparing real property investment opportunities, it is incumbent upon the investor to be sure that the techniques of analysis and general assumptions employed are similar enough to allow valid comparison.

There is an overwhelming number of techniques for calculating the return on investment. As

stated earlier, several of these are employed in the real estate industry. They range from the simple "Free and Clear Return" and the "Broker's Equity Return" to the much more complex "Modified Internal Rate of Return Method." Each of the various techniques has its strong points and shortcomings. Each has a place and a purpose. No one technique should be dismissed out of hand. The right one to employ is selected depending on the nature of the investment, the type of returns expected, the holding period, the method of dissolution - in general, the nature of the problem dictates the best technique to find the solution. In fact, many analysts use two techniques of analysis in the investment selection process. The minimum standards for both must be met. Only a skilled analyst can make these decisions and expect good results on a consistent basis.

It may be in the investors best interest to employ a consultant or a broker as a buyer's representative. In this way, the investor uses the skills of the professional consultant/broker to:

- 1.) Assist in developing investment selection criteria;
- 2.) To search for investment opportunities;
- 3.) To juxtapose and contrast the opportunities to the selection criteria;
- 4.) To develop assumptions and perform investment analysis in both absolute and comparative terms, consistently from one opportunity to another, and;
- 5.) To make specific real property investment recommendations.

In this manner the investor knows the professional is working on his/her behalf, that the undertaking is properly organized possibly leading to better results, that the assumptions employed and the tools of analysis will be consistent from one property to another. Hence, the investor knows that the results of the effort are valid and will lead to correct decision making. Finally, any investment made will be done so in the context of the investors overall strategic financial plan.

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