GRANT CARDONE'S

MULTIFAMILY FIELD GUIDE

46 CRITICAL REAL ESTATE INVESTING DEFINITIONS

Absorption

- The amount of inventory or units of a specific commercial property type that become occupied during a specified time period (usually a year) in a given market, typically reported as the absorption rate.

1. ABSORPTION

Adjustable-Rate Mortage (ARM)

- The interest rate for an adjustable-rate mortgage changes periodically. You might start with lower monthly payments than you would with a fixed-rate mortgage, but as interest rates go up or down your payment will adjust in the future. The reason people use ARM is because they have a business whereby they want to sell or refinance their property in the near term and not have to pay off a long term mortgage. Most of the debt done in the last three years on commercial real estate was done on ARMs

2. ADJUSTABLE -RATE MORTAGE

Amortization

- Amortization is the schedule of your mortgage payments spread out over an equal amount of time. In real estate, a buyer's amortization schedule is usually one monthly payment scheduled over a 15- or 30-year period of time.

3. AMORTIZATION

Annual Debt Service (ADS)

- The total amount of principal and interest to be paid each year to satisfy the obligations of a loan contract.

4. ANNUAL DEBT SERVICE

Appreciation

- This is the increase in the property's value over time.
- In multifamily the property's appreciation is based on the rent appreciation and cash flow going up. Inflation supports appreciation in this sense.
- The apartment's future value is not determined so much by the comparables of the neighborhood but the rents themselves.
- This is unlike residential properties like single-family residences, where their values and appreciation depend on the rest of the market and neighborhood.
  - **Cash Flow x Units + Time = Appreciation**

5. APPRECIATION

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Assumable Mortgage

- Assumable loan allows the new buyer to take over the seller's existing debt or loan.
- This is when a seller transfers all terms and conditions of a mortgage to a buyer.
- The buyer takes on the seller's remaining debt instead of taking out a new mortgage of their own.
- Assuming a loan becomes a great strategy when interest rates are going up and the new buyer can assume a lower interest rate.

6. ASSUMABLE MORTGAGE

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Break-Even Point

- The stage at which an investment produces an income that is just sufficient to cover recurring expenditure.
- For an investment in real property, the point at which gross income is equal to normal operating expenses, including debt service (the stage at which the next cash flow becomes positive).
- Also known as the default point.

7. BREAK-EVEN POINT

Bridge Loan

- A bridge loan is a short-term loan the buyer would take out against the property to finance the purchase. You will typically use it until you secure more permanent financing.
- It's usually taken out for a period of a few weeks to up to three years.

8. BRIDGE LOAN

Capital Expenditure (CapEx)

- Once-off expenditures such as a new roof or improving the clubhouse.
- Must be differentiated from Ongoing Expenses.
- Important for your lender and investors to know.
- E.g. How much money they will need to spend, or how much cash flow they have to dip into in order to take care of future once-off expenditures.

9. CAPITAL EXPENDITURE

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Capitalization Rates (Cap Rates)

- This represents the potential rate of return the property will pay the investor if there is no debt on the property.
- The lower the cap rate, the lower the return, the lower the risk, and usually, the better the property and location
- Cap Rate = Net Operating Income (NOI) ÷ Current Market Value of the Property
- E.g.
  - **NOI = $400,000**
  - **Current Market Value = $1,000,000**
  - **Cap Rate = $400,000 ÷ $1,000,000 = 4%**

10. CAPITALIZATION RATES

Cash Flow

- This is the total amount of cash transferred into and out of a business.
- This number is the HOLY grail of finance and should always be POSITIVE.
- Cash Flow = Effective Gross Income - Operating Expenses - Debt
- E.g.
  - **Effective Gross Income = $2 million**
  - **Operating Expenses = $1.2 million**
  - **Debt = $500,000**
  - **Cash Flow = $2 million - $1.2 million - $500,000 = $300,000**

Cash-On-Cash (COC)

- This is the rate of return based on the cash flow and the amount initially invested by the investors.
- Cash-on-Cash = Net Operating Income ÷ Initial Investment Amount
- E.g.
    - **Net Operating Income = $25,000**
    - **Initial Investment Amount = $250,000 (down payment for a $1,000,000 property)**
    - **Cash-on-Cash = $25,000 ÷ $250,000 = 10%**

Closing Costs (COC)

- These are the fees paid at the closing of a real estate transaction.
- Include: Attorney fees, credit search fees, due diligence fees, underwriting fees, origination fees, application fees, and recording fees.
- Should be factored into the price you paid for that property.

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Debt Service Coverage Ratio (DSCR)

- This measures how much cash flow your investment can generate and pay off your debt from the bank.
- In a down economy DSCR determines whether you stay afloat or lose it all.
- You have to know:
  - How much debt do you have?
  - Will your Net Operating Income cover it?
- Your NOI should be 25% greater than your debt load, creating a typical DSCR of 1.15 to 1.25.
- Debt Service Coverage Ratio = Net Operating Income (NOI) ÷ Debt
- E.g.
  - **Net Operating Income = $125,000 a year**
  - **Debt = $100,000 a year**
  - **Debt Service Coverage Ratio = $125,000 ÷ $100,000 = 1.25**

14. DEBT COVERAGE RATIO

Depreciation

- This is when properties decrease in value over time due to wear and tear or age.
- This decrease in value can be deducted from the property's annual real estate income tax, regardless of profit or appreciation.

Down Payment

- This means the costs you pay upfront for a property, excluding debt.
- E.g. Paying $250,000 down for a $1,000,000 property and financing the remainder with a loan.

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Due Diligence

- A physical, financial, and legal check of a property before you buy it.
- Don’t just focus on looking for a bad roof, a paint job, or potholes in a property, look for millions of dollars—on what the property can potentially do!

17. DUE DILIGENCE

Economic Occupancy

- This is the percentage of the property's income that is actually collected from the tenants.
- This is a very important and oft-ignored number, because it tells you how much you are getting paid by the existing tenants, which makes this a more valuable figure than the Physical Occupancy Rate.
- This number is typically lower than physical occupancy.
- Economic Occupancy = Effective Gross Income ÷ Gross Rental Income
- E.g.
  - **Effective Gross Income = $1,000,000**
  - **Gross Rental Income = $1,200,000**
  - **Economic Occupancy = $1,000,000 ÷ $1,200,000 = 83%**

18. ECONOMIC OCCUPANCY

Effective Gross Income (EGI)

- This is the TOTAL amount of real income that was actually collected.
- This is a VERY important number and it's more important than Gross Rental Income or Gross Scheduled Income.
    - **Effective Gross Income = (Gross Scheduled Income + Other Income) - Vacancy Costs - Collection Losses**

19. EFFECTIVE GROSS INCOME

Exit

- This refers to how you as the owner are going to sell the property in future.
- You should not overlook this because this is how you and your investors make money.
  - You can profit.
  - The next buyer can still get a good return on his investment.
- To properly calculate the exit of your purchase, you must know how to calculate future values.
- For a profitable exit, your property must increase in rent and produce more NOI.
- E.g.
  - **Let's say I buy a $50 million, 240-unit building with a Cap Rate of 6%.**
  - **Each unit currently rents for $1,500 a month. In 10 years, we can assume rents might increase by $500 to $2,000 a month.**
  - **Future value = 240 units x $500 (rent increase) x 12 months x 95% (occupancy) = NOI increase of $1,368,000 or $1.368 million**
  - **Increase in value = NOI increase ÷ 6% Cap Rate = $1,368,000 ÷ 0.06 = $22.8 million**
  - **In 5 years, the property can be sold for $50 million + $22.8 million = $72.8 million**
  - **So, what did we make on the deal including the following?**
    - $15 million return of your original capital invested
    - $900,000 x 10 years = $9 million in cash flow
    - $22.8 million in profit from increasing your NOI
  - **You make $46.8 million on your original $15 million investment for a total return of 312%.**

Expense Ratio

- Expense Ratio = Total Operating Expenses ÷ Gross Operating Income
- E.g.
  - **Total Operating Expenses = $50,000**
  - **Gross Operating Income = $100,000**
  - **Expense Ratio = $50,000 ÷ $100,000 = 50%**
- Look for expense ratios of 35-44%, and use a 50% underwriting as a worst-case scenario.
- Be skeptical and wary of expense ratios below 35%.

Gross Rent Multiplier (GRM)

- This is the number of years it would take for a property to pay for itself based on the Gross Scheduled Income.
- The lower the number, the better the return, but it doesn't mean it's a better property.
- Gross Rent Multiplier = Purchase Price ÷ Gross Scheduled Income
- E.g.
  - **Purchase Price = $12 million**
  - **Gross Scheduled Income = $2 million**
  - **Gross Rent Multiplier = $12 million ÷ $2 million = 6 years**

Gross Rental Income

- This is a number used by the broker to show the total possible income if every unit is rented at full price each month. This figure is used by the broker and is almost meaningless.

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Gross Scheduled Income (GSI)

- The maximum possible annual income in rent collections generated by your property if it is 100% occupied, 100% of the time.
- 100% occupancy all the time will never happen, and if it does happen, your rents are too low.
- This is also known as Gross Potential Income.
  - **Gross Scheduled Income = No. of Units x Market Value Rent x 12 months**
  - **E.g. Gross Scheduled Income = 200 units x $800 rent x 12 months = $1,920,000**

24. GROSS SCHEDULED INCOME

Interest

- Money paid regularly at a particular rate for the money you have borrowed, expressed as an annual percentage of your outstanding loan, e.g. 3.5-8%
- This should not be confused with your principal.
- Remember: The interest you pay on the loans for apartment deals is 100% tax deductible, with no limit on how much can be written off.

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Interest-Only Loans

- A loan that allows the borrower to only pay interest on the loan, and not pay the principal down.
- If you put enough down at time of purchase, that is considered a principal paydown.
- This is my preference, because by not paying the principal every month, I can increase cash flow for myself and my investors.
- I might even ask the bank if I can increase my down payment so I can get an interest-only loan for a longer period of time.
- Remember:
  - You have to have great credit
  - You have to find the right lender who loves multifamily deals and the security they provide as a long-term investment.

26. INTEREST-ONLY LOANS

Leverage

- This is your ability to use debt to buy real estate, instead of paying 100% of the purchase price.
- You will need to overcome the mentality that all debt is bad, if you want to understand the power of leverage.
- Using leverage helps you to increase your Cash-on-Cash return, as long as the property generates more cash than the interest paid on the loan.
- Remember: Cash-on-Cash = Net Operating Income ÷ Initial Investment Amount
- Example 1: Using Cash Only and No Debt for a $1 million property
  - **Initial Investment Amount = $1,000,000**
  - **Net Operating Income = $100,000**
  - **Cash-on-Cash = $100,000 ÷ $1,000,000 = 10%**
- Example 2: Putting 25% Down and Using a 4% Interest-Only Loan for a $1 million property
  - **Initial Investment Amount/Principal/Down = $250,000**
  - **Net Operating Income = $100,000**
  - **Annual Interest-Only Loan Payment = 4% x $750,000 = $30,000**
  - **Income after paying interest-only loan = $70,000**
  - **Cash-on-Cash = $70,000 ÷ $250,000 = 28%**
- Note that in Example 2, your Cash-on-Cash is almost triple the return of paying cash only!
- That is the power of leverage; it explodes your total cash flow.

Loan Term

- This is the amount of time you have to repay the loan.
- Not to be confused with the amortization period: The amount of time over which the loan's payment is calculated at a certain interest rate.
- The term is a portion of the amortization period.

Net Income Multiplier

- This measures how many times higher the property's purchase price is compared to net operating income produced by the property.
- You can use this number to evaluate the price of a property, or to figure out how many years you will need to recover your initial investment.
- The lower this number is, the better.
  - **Net Income Multiplier = Purchase Price ÷ Net Operating Income**

29. NET INCOME MULTIPLIER

Net Operating Income (NOI)

- This is a VERY important calculation to understand.
- Banks and lenders care about NOI first.
- It is what determines the value of the property.
- The higher the NOI, the lower the debt, the more cash flow.
- If you can increase the NOI, you can increase the price the next investor pays for your property, and increase your profit when you exit.
- Think about the future as well – What will the NOI be 3 months from now, up to 36 months from now?
  - **Net Operating Income = Effective Gross Income - Operating Expenses (Excluding Debt Payments)**

Occupancy Rate

- This is the number of units occupied at the property or "heads in beds".
- It has nothing to do with how much money is being collected.
- No matter what a broker tells me, I usually keep this figure at 92% in my other calculations to plan for the worst-case scenario.

31.
OCCUPANCY RATE

Operating Expenses

- This is the total amount of ongoing expenses you will incur from day-to-day operations on the property.
- These include: taxes, payroll for property managers and leasing managers, maintenance and repair, turnover, marketing, utilities, administration, insurance, etc.
- Excludes: debt, major capital expenditures like a new roof.

Other Income

- Includes collections from utility reimbursements, water, laundry, application fees, late fees, pets, parking, valet, trash, etc.
- These numbers can indicate that there are issues with the property , e.g. if you see a significant amount of late fees that mean tenants are not paying their rent.
- If you DON'T see a certain source of Other Income, it's an opportunity to add it to your property and increase your cash flow and NOI.

Physical Occupancy

- This is the number of units rented divided by the total the number of units available.
- E.g. If I have 100 units and 95 of them are occupied, that is a 95% physical occupancy.
- This is less important than economic occupancy.

34. PHYSICAL OCCUPANCY

Price Per Square Foot

- Know what you're paying per square foot and how it compares to other products of a similar quality/location.
  - **Purchase Price ÷ Total Square Footage = Price Per Square Foot**

Principal

- The original sum borrowed to pay for the property, excluding interest.
- It is to be paid down over the loan term.

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Principal & Interest Loans (P&I)

- This refers to the main loan (principal) pay down and the interest paid to the lender for the loan.
- Each payment to the bank includes interest and some principal paydown that over the life of the loan will result in a zero balance when the loan completes its term.
- Your property's income should be enough to cover these loan payments.
- It is a myth that owing no money on a piece of property is financial freedom. I will never not owe money on my property. Why? Leverage.

37. PRINCIPAL & INTEREST LOANS

Pro-Forma

- This document is a projection of the revenue and expenses for the property.
- It can be projected 12 months or 5 years into the future.

Property Management Expenses

- These are the total expenses needed to maintain your property.
- It can also be called “total property expenses”.
- This includes the management fee paid to the property manager.

39. PROPERTY MANAGEMENT EXPENSES

Purchase Price

- This is the price of the property plus all closing costs, legal fees, document fees, financing fees, and costs of any rehab you need to do during the beginning of your deal.

40. PURCHASE PRICE

Rehab Cost

- This is how much it costs to renovate and fix the building.
- Familiarize yourself with the location, property, and its problems on your own before getting estimates from local contractors.

41. REHAB COST

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Rent Roll

- A document with information about every single unit in the apartment building
- Includes the tenants' names, market rent, actual rent, unit number, square footage, move-in date, lease-start date, lease-end date, security deposit amount, and any outstanding balances.
- This is one of the most important documents you need to analyze in a deal.
- Use it to confirm the Effective Gross Income and your Net Operating Income.
- You can also use it to look for opportunities to boost the building's value.

Replacement Cost

- This is how much it would cost to build or rebuild a property.
- Find out if you're buying the property below replacement cost by asking contractors or estimators.
- This number tells you whether developers find it economically feasible to build a new property in your neighborhood and could potentially take away your tenants.

43.
REPLACEMENT COST

T-12 Statement

- This is also known as a trailing 12-month profit and loss statement or an operating statement.
- An important document showing ALL information about the last 12 months of revenue and expenses for an apartment building.
- This is more important than the pro-forma because it shows the actual history of the building, not projected values.

Underwriting

- Underwriting helps the lender determine how much risk they are willing to accept.
- This involves doing your due diligence and gathering as much data as you can about the property, calculating how the property will probably perform in the future, and determining the future value of the property.
- I use several underwriters on a deal so I can determine the worst-case scenario and make sure the deal is profitable.
- I look at the GSI (Gross Scheduled Income), study the EGI (Effective Gross Income), deduct operating expenses to reveal the NOI (Net Operating Income) and use this data to calculate a Cap Rate to determine if the deal is worth pursuing.

Vacancy Rate

- This is the percentage of vacant units.
  - **Vacancy rate = no. of unoccupied units ÷ total number of units**
- By paying attention to it, you can learn the trends of the property and its weaknesses and or strengths.
- E.g. I once bought a property that was cash flowing with a 28% vacancy rate. I knew if I could get the number down to 8%, I would make tremendous amounts of money.

46. VACANCY RATE

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