

LESSON SEVEN: PROPERTY PROFITABILITY

1.1 CASH-ON-CASH RETURN

The cash on cash return measures the unleveraged return on the property. This return can be compared to other investments, such as stocks, bonds, and treasuries. The formula for calculating cash-on-cash returns is listed below:

QUICK FORMULA:

Stabilized Cash-on-Cash Return =
Stabilized NOI / Total Project Cost

Example: \$950,000 / \$10,000,000 = 9.5%

1.2 LEVERAGED CASH-ON-CASH RETURN

Leveraged cash-on-cash return is a key measurement that focuses on the sponsor's equity return. This measurement takes into account the leverage or debt used on the property. The use of the debt can greatly increase returns. There are three primary components of debt:

- **Amount or leverage:** For example, 50%, 60%, 75%, 80% of value or cost.
- **The cost of debt:** The interest rate or spread.
- **Amortization:** The repayment of debt via monthly payment (i.e. the principal part of the P&I payments).

Equity returns are more affected by the amount of leverage versus the interest rate or amortization. Leverage also increases project risk. If cash flow is interrupted and debt service cannot be paid, the project will default. The formula for calculating leveraged cash-on-cash return is listed below:

QUICK FORMULA:

Stabilized Leveraged Cash-on-Cash Return =
Stabilized Cash Flow / Sponsor Equity Contribution

Example: \$190,000 / \$2,000,000 = 9.5%

1.3 POSITIVE LEVERAGE

Positive leverage occurs when the cost of debt (leverage) is less than the project cash on cash return. In these cases, the leverage is “accretive,” as the property is producing a greater amount of cash flow than its debt service. In cases where there is negative leverage, the sponsor must pay interest current from other sources. This is a bad situation and typically deals do not get done at this level. Thus, in cases where low rate fixed financing is on a property and is assumable, the building may have additional value because of the “positive leverage” of the financing in place.