Crunching Numbers Now Will Save You From Being In a Crunch Later

by Douglas K. Rutherford, CPA, MTX

As a CPA specializing in the real estate industry and working with hundreds of real estate investors, one of the biggest mistakes I see investors making today is buying real estate without first crunching the numbers to determine the property's cash flow and whether the property will generate a respectable return on investment.

Although it is true that you can make a lot of money in real estate, it is also equally true that you may not make enough money to make it worth your time or you may even potentially lose money.

Successful investors know how to crunch the numbers (or they hire people like me) to determine whether a property meets their investment objectives. They make offers (or pass) on "deals" based on the story the numbers are telling them about the property.

Now, perhaps math was not one of your best subjects in school and you are saying to yourself, "I'd rather take a long walk on a short peer than try to figure out all those numbers." Well, with the software available today, let me assure you that with a little practice, you will be crunching numbers with the best of them in no time. Cash flow analysis is not optional, it is absolutely necessary if you are serious about making money in real estate.

If not doing enough number crunching is one of the biggest mistakes investors make, probably the biggest mistake made is what we call "analysis paralysis" or doing too much analysis and never making a decision. Many investors get so wrapped up in the numbers that they miss opportunities or even worse, get frustrated and quit.

To be a successful investor, you need to seek a middle ground between not enough and too much number crunching. You need to create or use a system to quickly analyze the cash flow of a property, determine how much you are willing to pay for the property, and then make an offer before someone else does.

The first step in analyzing a property's cash flow is having the right tool, a cash flow model. Although a model can be done by hand, due to the complexity of calculating cash flow and the many variables that are taken into consideration, we highly recommend using software to crunch the numbers for you. With software, you can quickly and accurately change any number to see the immediate effect, e.g. lowering the purchase price or increasing rental income.

Your cash flow model, at the very least, should be able to calculate annual net cash flow after income taxes, cash-on-cash return, and return on investment every year over at least five years. Annual net cash flow takes into consideration your gross rental income less expenses, vacancies, mortgage payments, capital improvements, and income taxes. Dividing your annual net cash flow by your initial investment (purchase price less debt) gives you the cash-on-cash return. This ratio shows you how your money is working for you much like you would view the interest paid on a certificate of deposit. The return on investment is computed using the Internal Rate of Return (IRR) or Modified Internal Rate of Return (MIRR) ratios.

Keep in mind, your analysis does not have to be 100% accurate. All you are looking for is a property that will generate positive annual cash flow and will give you a reasonable appreciation rate over time. Wealth comes with accumulating many of these cash flow positive properties.

In 1993, I founded a software company to produce affordable software that helps investors quickly and easily evaluate the cash flow and investment return of potential real estate deals. Whether you use software like ours or use your own cash flow model, your chances of success in real estate greatly improve when you "crunch the numbers."

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