

Terms & Definitions

Net Operating Income (NOI) is a property's gross rental income reduced by all expenses except for loan payments, income taxes, mortgage insurance premium (MIP) payments and sometimes funded reserves.

Debt Coverage Ratio (DCR) is a property's net operating income divided by the amount of debt payments. Lenders use this calculation to determine the remaining operating cash flow after the debt payments.

Loan-to-Value Ratio (LTV) is the outstanding debt divided by the value of the property. This ratio is used to determine the amount of leverage and property equity. The debt balance can be the beginning or end-of-year balance. The property value used can be the contract price or the fair market value at the end of the year.

Capitalization Rate (Cap Rate) is the net operating income (NOI) divided by either the property's contract purchase price or its fair market value.

Cash-on-Cash Return is the net cash flow divided by the initial investment (down payment). The calculation does not take into account the time value of money or change in the property's equity.

Cash-on-Cash Return with Equity Build-up modifies the cash-on-cash return calculation by adding the property's net change in equity for that year to the numerator and adding all previously generated equity to the denominator of the cash-on-cash return ratio. The calculation calculates the return on the property equity, i.e. the return on the cash that is "tied up" in the property.

Net Present Value (NPV) converts future dollars into present-day dollars by discounting (reducing) the future cash flow of a property by a given rate or percentage. The initial investment (down payment) is subtracted from the discounted dollars to derive the NPV. A positive NPV means that the property will generate a higher return than the given rate or percentage used to calculate the NPV amount.

Gross Rent Multiplier (GRM) is a property's fair market value divided by its gross rental income.

Mortgage Insurance Premium (MIP) Payments are insurance premiums charged by a lender to protect that lender against loss from a mortgager's default. The rates are charged on the balance of the loan and may be paid annually, monthly, or in some combination of the two (split premiums).

Internal Rate-of-Return (IRR) is the most widely used method of valuing a property's annual cash flow stream. Since a property's cash flow is earned in the future, those future dollars must be converted to present-day dollars. The IRR calculation discounts (reduces) the property's future cash flow at a rate (i.e. percentage) so that the sum of all cash flow for a specified time period is equal to the initial investment. The rate or percentage needed to do that is the IRR. In other words, IRR is the discount rate at which Net Present Value (NPV) is zero.

Modified Internal Rate-of-Return (MIRR) modifies the IRR to avoid the drawbacks of the traditional IRR. The IRR implicitly assumes that all cash flow is either reinvested or discounted at the computed IRR rate. In reality, a property's cash flow probably will not be reinvested at the computed IRR rate, but rather earn zero or a small amount of interest. The MIRR eliminates the reinvestment assumption by utilizing user stipulated reinvestment and borrowing rates.

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