Performance analysis a must on multifamily investments - by Russell Gullo

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A “financial physical” will show owners of multifamily investment property how they can double, triple and in some cases even quadruple the size of a real estate investment portfolio by using their current equity in a property that they own today. This is possible with the use of leverage and Section 1031 of the Internal Revenue Code, which is the opportunity to pay no tax when disposing of income-producing, investment held property, or secondary residences.

The whole basis of a “financial physical” is to point out that equity grows from the time that you acquire an investment property throughout the holding period due to the principal pay-down of a mortgage and the increase of value through appreciation. By using a 1031 Exchange you dispose of your current property then use 100% of your new equity position together with the use of leverage, acquire a larger portfolio of investment properties. This will allow you to increase the size of your real estate investment portfolio, by just using your current (increased) equity position in the properties that you own today. On the other hand, a “performance analysis” is another tool used in the multifamily investment property arena to determine how “healthy” your current property or properties are performing from a cash flow position.

As you know, there are two types of cash flows associated with any income-producing property. Cash flow before taxes and cash flow after taxes. Your cash flow before taxes should increase over your holding period as you increase your rents for the most part. But your cash flow after taxes, when measured on an after tax return basis, will diminish as time goes on. The reason being is that, as you go through the holding period of your real estate investment, your interest expense portion of your debt service becomes smaller, which allows you to shelter less cash flow and your depreciation expense stays the same or shrinks. Again as you increase your rents and increase your cash flow before taxes, you are sheltering less cash flow after taxes, meaning you are putting less cash flow into a national bank. This really can be proven by dividing your cash flow after taxes by your current equity position in your subject property today. Again you need to use your equity today, not the equity used when acquiring the subject property that you are having a “performance analysis” conducted on. The wake-up item, is it does not matter how much money you make (cash flow before taxes), but how much money you keep (cash flow after taxes). In some cases, especially those individuals that are mortgage free and fully depreciated, have no shelter. Uncle Sam can take as much as half of their cash flow each year in the form of taxation depending on their tax rate. And by having no shelter, they are giving up one of the four basic benefits of a real estate investment.

A “performance analysis” can also show an individual that their after-tax return diminishes the longer they hold an investment property in most cases. This can be proven by using any “cash flow analysis program.” You will be able to determine when to sell your asset as your after tax return annually reaches a point where the risk vs return ratio does not meet your financial comfort level. As a rule of thumb today, this happens between five and ten years. In addition, a “performance analysis” is used to show an investor how they can increase both cash flow before taxes as well as increasing cash flow after taxes. This can be accomplished by upgrading their real estate holdings by disposing of an investment property that is producing a diminishing rate of return on an after-tax basis. With the use of leverage and Section 1031 of the Internal Revenue Code, you have the ability to increase your cash flow and in most cases also increase the size of your real estate investment portfolio by using your additional equity growth, just like with a “financial physical.”

So, if you want to know how “healthy” your real estate investment is producing, you need to have a “performance analysis” conducted.

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