



## Return on Equity - What a Non-Traditional Approach Can Reveal

By Frank Gallinelli

We usually think of Return on Equity (ROE) as a straightforward investment measure. That's understandable, because the traditional method of calculating ROE is pretty clear-cut: Take your cash flow after taxes and divide it by your initial cash investment.

Return on Equity = Cash Flow After Taxes / Initial Cash Investment

This in fact is just a hop-and-step away from another popular measure, Cash-on-Cash Return (aka Equity Dividend Rate). The only difference is that Cash-on-Cash uses the cash flow *before* taxes.

Whichever of the two appeals to you more – and we'll stick with ROE for simplicity here – the measurement will give you a quick sense of how your cash flow measures up to it's cost.

There is a non-traditional approach, however, that we use in our *Real Estate Investment Analysis* software – an approach that can tell you something quite different about your income-property investment. This not-so-standard method differs in its definition of "equity." Instead of looking at the actual dollars invested, you look instead at potential equity at a particular point in time. That equity is not what you invested, but rather the difference between what the property is worth and what you still owe in mortgage financing. So, if you look at the equity after one year (or two or three), you'll be taking into account the growth or decline in the property's value as well as the amortization of your mortgage.

Our non-standard formula now looks like this:

Return on Equity = Cash Flow After Taxes / (Resale Value less Mortgage Balance)

This measurement becomes interesting if you apply it in a multi-year projection. Let's assume that you make projections about a property's performance over a number of years and that you include in those projections the potential resale value and mortgage balances for each year (as we do in our REIA software). Whether or not you actually sell the property in any particular year, you accept the idea that your equity at a given time is the difference between what your property is worth and what you owe on your mortgages. By this reasoning, your return on equity measures not how you cash flow performs in relation to how much you originally invested, but rather how it performs in relation to how much you currently have "tied up" in this property.

What difference does it make? Consider this situation; you project that your property's cash flow and resale value will increase each year but when you calculate the ROE you find the following:

	Year 1	Year 3	Year 5	Year 7	Year 9	Year 11
RETURN ON EQUITY	8.10%	9.54%	8.30%	6.06%	4.67%	3.83%

You observe that your ROE starts going down at some point even though the value of the property and the Cash Flow After Taxes continue to go up. Is this a mistake? No, it can occur if the equity grows at a rate that is faster than the growth in cash flow. With our non-standard definition, your equity can grow when the value of the property increases or the mortgage balance decreases – or both. Mortgage amortization typically accelerates over time, so that alone can accelerate the growth in your potential equity. ROE is a simple ratio, so if the equity grows faster than the cash flow, then the Return on Equity will decline over time.

What does this decline mean to you as an investor? It means you have more and more potentially usable cash tied up in this property and that the return on that cash is declining. Is that a bad thing? Not absolutely – it depends on your alternative uses for the money. If you were to refinance, could you purchase another property and earn a greater overall return? If you sold, could you use the funds realized to move up to a larger or better property, one with a better long-term upside?



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If the answer to any of these questions is yes, or even maybe, then being tuned into to the message from this alternative method calculating ROE can give you the heads-up you need to maximum your investment dollars.

To make this kind of ROE projection – and to analyze all facets of your income-property investment – use our *Real Estate Investment Analysis* software with it's numerous rate-of-return, cash flow and resale metrics.