Seven Things You Need to Know Before You Buy Rental Property — Thing Seven: The Return on Your Investment

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I have saved the most important thing to know about a rental property before you buy it, THE RETURN ON YOUR INVESTMENT, for the last in this series of articles. After all, we call ourselves real estate investors because we buy and operate real estate as an investment. We expect to benefit short term from cash flow and tax benefits, long term from appreciation and even better cash flow when we eliminate mortgage debt service.

Yet all too often, we get caught up in the appearance of a property we brought back from a disaster to pristine condition, or we empathize with the problems of our tenants and put the profitability of each property second, or even a distant third to other considerations. When I analyze a property for investment, I look first at the cash flow. I do have properties on which I make less than they cost to operate, some because they are vacant waiting to be renovated, others because I had to spend more than I thought to get them renovated. Some are in locations where the market hasn't caught up to my vision of what the market would, should and someday will be in the area, while others lag in income because I don't get the rent I should or thought I would from particular tenants. None of these properties started out with the expectation that I would carry them. Every property I bought looked good on paper and in my mind before I closed on it. Later events increased operating costs, decreased income or both.

Because contingencies can, and often do affect your bottom line after you buy a property, you need to buy with a cushion for those contingencies so not getting every penny in income you expected doesn't leave you upside down. You must have extra cash flow to pay more than you anticipated in taxes, repairs, utilities, or my personal favorite, legal fees. Plan so an extra expense doesn't take you over the line into a negative cash flow spiral from which you can't recover.

There are probably almost as many rules of thumb followed by successful investors in planning their returns as there are investors, but most revolve around certain key elements. My first step is to look at all the current income and all the current expenses of the property I am considering, and compare both to the income and expenses of my most similar units. Do all the numbers end up in the same ballpark, and if not, why not?

Next, compare that income in the building you want to the asking rents for other units in the area advertised in the papers and online. Honestly check the pictures online and see whether owners of nicer units in the area are asking for less rent, or units in poorer condition are advertised for more rent than the building you want to buy. Remember that units often rent for less than asking rent, but rarely rent for more. In fact, other than extra pet rent, or a lease for less than a year, I don't think I've ever rented for more than advertised rent.

If the rents reported by the seller for the building you want look high for the neighborhood, look the leases over carefully for waivers of security deposits, free months' rent offers and leases in the building for less than a year. These things may make short term cash flow look good, but seem to find market level on your first renewal cycle.

Test expenses the same way. If the expense seems too low, don't just accept the seller's word, but ask for supporting records. If the records look too cheap, check the bills. If the bills look too cheap, don't be afraid to look even deeper. One of the most expensive cash flow mistakes I made was accepting an electric bill that just seemed too low. It turned out that the bill was too low, even for over two years after I bought the building. When the electric company eventually investigated, they found a seal had been cut by someone before I bought the building, and the meter jumped so most of the electricity used wasn't recorded on the meter inside or registered by the electronic reading device. Since nobody came to read the meter, nobody saw the cut and carefully replaced meter seal.

I kissed any hope of a good return goodbye, and paid $1,000.00 dollars a month for two years to cover the electricity I had unwittingly "stolen" while the meter was jumped. To add more pain, the utility used the opportunity to replace a direct meter with a demand meter, so I paid much more due to peak demand.

Once you are comfortable with the income and expenses, do you show a profit on cash flow? I like to see $200 per unit per month in projected cash flow after all expenses. That way, even if my expenses creep up faster than income, I have room to absorb the extra.

Next, I like to estimate a vacancy rate and make sure that even with higher vacancy than I really anticipate, I can break even. I find that being conservative in my calculations before I buy may cause me not to buy some good properties, but leaves me with a better mix overall.

Although this article is about what you should know before you buy rental units, your cash flow analysis should continue after you buy a property. Every year you should review the return on every property you own. Tax time is a good time to pull out the cash flow analysis you did when you were buying, and see what expenses have changed, and why. Are you able to refinance and lower your interest rate without stretching the payments out too far?

Look at income, too. Are you able to raise rents to keep up with inflation in your expenses? If you don’t like the answers you see, and can’t plan to improve your diminishing return, you have to decide whether to wait for better cash flow when you pay off the mortgage, or sell the building now and find another with a better return. Remember, investors who maintain a good rate of return get rich slowly, while those who ignore the return on their investment often go bankrupt quickly.

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