The Real Estate Investing Guide

> A rental only works if the numbers work. Here is how to read a deal the way investors do, from net operating income to cash-on-cash return.

Real estate looks complicated from the outside, but a rental deal comes down to a handful of numbers. Learn to read them and you can size up a property in minutes and tell a good deal from a money pit. This guide walks through the figures that matter and how they fit together.

Start with net operating income

Net operating income, or NOI, is what a property earns after real costs but before the mortgage. Take the rent, subtract a vacancy allowance for empty months, then subtract operating expenses like property tax, insurance, a maintenance reserve, and management. What is left is the NOI.

Here is a worked example. A property renting for 2,500 dollars a month brings in 30,000 dollars a year. Take out 5 percent for vacancy and it collects 28,500. Subtract 8,700 of operating expenses and the NOI is 19,800 dollars. NOI stops before the loan, so it measures the building itself, no matter how you finance it. The Cap Rate and Rental Property ROI calculators both start here.

Cap rate and cash-on-cash return

Two returns come out of the NOI. Cap rate is NOI divided by the price, the unleveraged yield you would earn buying with cash. On a 300,000 dollar property, an NOI of 19,800 is a 6.6 percent cap rate. It lets you compare properties on equal footing.

Cash-on-cash return brings in the loan. It is your annual cash flow, which is NOI minus the mortgage, divided by the actual cash you put into the deal. On that same property with 25 percent down and a 7 percent loan, the mortgage eats most of the NOI, leaving about 1,837 dollars of cash flow a year, roughly 153 dollars a month. Against 91,000 dollars of cash invested, that is a 2.02 percent cash-on-cash return. Thin, which is typical at today rates, and exactly why you run the numbers before you buy.

The 1% rule and other quick screens

Before a full analysis, investors use fast screens to sort a long list of listings. The best known is the 1 percent rule, which says the monthly rent should be at least 1 percent of the all-in cost. A 300,000 dollar property should rent for about 3,000 dollars a month to pass. Many properties in expensive markets fail it, which is a signal that the deal leans on appreciation rather than cash flow.

Treat these screens as a filter, not a verdict. A property that passes still needs a real cash-flow check, and one that fails can still work with a larger down payment. The 1% Rule calculator does the screen in seconds so you can move on to the deals worth a closer look.

The BRRRR method: recycling your cash

BRRRR stands for buy, rehab, rent, refinance, repeat. You buy a run-down property, fix it up so it appraises higher, rent it out, then refinance based on the new value to pull most of your cash back out and roll it into the next deal.

An example shows the appeal. Put 180,000 dollars into a purchase, rehab, and closing. The work lifts the appraised value to 220,000, and a lender refinances at 75 percent of that, a 165,000 dollar loan. That 165,000 comes back to you, leaving just 15,000 of your own cash in the deal. Because so little cash stays trapped, even a modest 56 dollars a month of cash flow is a 4.5 percent cash-on-cash return on the money left in. The catch is the appraisal. If the after-repair value comes in low, the refinance returns less and more of your cash stays stuck, which the BRRRR calculator lets you stress test.

Key takeaway. Make a rental work on cash flow first, using NOI, cap rate, and cash-on-cash return. Appreciation is a bonus, not a plan.

Assumptions

- Net operating income is rent after a vacancy allowance minus operating expenses, and never includes the mortgage. Cash flow is that income minus the loan payment.
- Rent, expenses, appreciation, and financing terms are estimates the investor supplies. Depreciation and other tax effects are not modeled here.

Sources

- Consumer Financial Protection Bureau, mortgages
- U.S. Bureau of Labor Statistics, CPI for rent of shelter