How to calculate return on investment on rental property

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With real estate values still depressed in most markets, prudent investors are picking up commercial and residential rental real estate at below-market rates. But how do investors know that a particular piece of property is worth pursuing?

The fact is, most rental properties are long-term investments. Rather than shooting for significant returns in the short-term, most real estate investors expect monthly rental income to cover carrying costs while the owner takes advantage of tax breaks, write-offs and appreciation. Over the long term, as rental rates rise and mortgage rates stay steady, the investor will realize a positive cash flow.

To make this strategy work, the investor must make sure that the monthly rental income will cover those carrying costs - or be prepared to cover the difference until the property starts to break even.

So how do you calculate the sale price at which rental income would offset carrying costs?

The first step in determining the break-even point is to thoroughly analyze the market where the property resides, including prevailing rental rates, vacancy rates and market trends. For example, in what ways are the demographics of the area changing? If your tenants commute to work, is the property close to public transit? Is it in a good school district? These and other factors will determine whether rental rates are likely to increase or decrease in coming years.

After determining the prevailing rental rates and confirming that the market trends are favorable, you're ready to determine the purchase price that will allow you to break even.

Calculating the

Break-Even Price

One strategy for quickly determining whether or not a property is worth pursuing is known as the "duct tape formula." This formula patches together several figures to arrive at a workable sale price, as follows:

1. Determine the prevailing market rental rate (e.g., $1,500).

2. Determine the current mortgage interest rate (e.g., 5.25 percent).

3. Add a factor of one (5.25 + 1 = 6.25) and add two zeros in front of this number (.00625).

4. Divide the number into the prevailing rental rate ($1,500/.00625 = $240,000) to determine the target sale price.

Here is the rationale behind this formula: After making a 20% down payment, you are left with $192,000 to finance. At an interest rate of 5.25%, the monthly mortgage would come to roughly $1,060 plus $300 for taxes and insurance, or $1,360. (Taxes and insurance rates vary by jurisdiction, so make sure to check the rates in your area.)

But you're not done yet. Next, you add a 10% buffer for vacancies, repairs, maintenance and utility costs. If you expect a higher vacancy rate or volatile utility and repair costs, then consider adding in a higher buffer (i.e., increase the factor you use in Step 3, above).

With a 10% vacancy/repair buffer, this hypothetical property would cost just under $1,500 per month. So, assuming vacancy rates and maintenance costs are relatively stable, you should be able to break even on this property at a selling price of $240,000. As prevailing rates increase, you would see an increase in the return on investment.

Note that the formula above only works for owner-managed properties where the owner makes at least a 20% down payment. A higher down payment would allow the investor to break even on a higher-priced property. If you intend to hire a property management company, add 10% to 20% for management fees.

Is It Worth It?

Real estate is often an attractive investment, especially during periods of volatility in the securities markets. Deciding whether to invest in rental real estate versus other types of investments requires an understanding of the degrees of risks and returns on each type of investment, as well as consideration of your risk tolerance.

So before you jump on that great investment deal, make sure you solicit input from your accountant and other advisors regarding the potential risks and returns of all of your options.

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