How to Calculate ROI on

RENTAL PROPERTIES

Rental properties provide a return on your investment in different ways. You gain equity, generate operating income, and your property value appreciates over time. *Win-win-win!*

Use the following guide to see how profitable your rental could be over the long haul.

Before you begin, decide on the number of years you plan to own the property. (If you aren't sure, use the payoff date for your loan.)

Note that these formulas do not account for inflation.

Step 1 of 4:
Calculate Net Operating Income (NOI)

Net operating income is the money you will use to make your loan payments (debt service) and pad your profit pocket after you have paid for the operating expenses and reserves on your SFR rental property. Calculating this number is very important as it is the primary instrument with which you will secure long-term financing for your rental. The NOI of the property determines the amount of debt you can secure from your lender via the ratio of your NOI into your loan payment (debt service coverage ratio).

The calculation looks something like this:

Calculate Net Operating Income

Total Investment	$262,000
Loan	$209,600
Down	$52,400

RENTAL ECONOMICS	MONTHLY	ANNUAL
Gross Rent	$2,500	$30,000
Total Reserve & Fees	($850)	($10,200)
• Vacancy Reserve (5%)	($125)	($1,500)
• Maintenance Reserve (8%)	($200)	($2,400)
• Property Management Fee (8%)	($200)	($2,400)
• Property Taxes (8%)	($200)	($2,400)
• Insurance (5%)	($125)	($1,500)
NOI	**$1,650**	**$19,800**
NOI Capitalization Rate		7.56%
Loan Payment	($1,408)	($16,891)
Debt Service Coverage Ratio	1.17x	1.17x
Net Profit	**$242**	**$2,909**

A good rule of thumb for your monthly gross rent is to ensure that one month rent is equal to or very close to 1% of your total SFR investment. In this case, $2,500 in gross rent is just shy of 1% of $262,000 (the total investment). Another important rule of thumb is to make sure that your ratio of NOI into the total investment—your NOI capitalization rate—is greater than your cost of money. This will ensure that your property will have positive cash flow. In this case, the NOI capitalization rate of 7.56% is greater than the 7% interest rate on the long-term debt. Thus, a positive cash flow of $2,909 in year one.

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Step 2 of 4:

Calculate Your Growth Rates to Test Your Cash-On-Cash Return Over Time

Calculating your growth rates and your growing cash-on-cash return over time will give you confidence in the long-term economic viability of your property.

Calculate Your Growth Rates & Exit Date To Arrive At Exit NOI

Rent Growth	3%
Opex Growth	2%
Cash Invested (Down Payment)	$52,400

RENTAL ECONOMICS	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Gross Rent	$30,000	$30,900	$31,827	$32,782	$33,765
Total Reserve & Fees	($10,200)	($10,404)	($10,612)	($10,824)	($11,041)
• Vacancy Reserve (5%)	($1,500)	($1,530)	($1,561)	($1,592)	($1,624)
• Maintenance Reserve (8%)	($2,400)	($2,448)	($2,497)	($2,547)	($2,598)
• Property Management Fee (8%)	($2,400)	($2,448)	($2,497)	($2,547)	($2,598)
• Property Taxes (8%)	($2,400)	($2,448)	($2,497)	($2,547)	($2,598)
• Insurance (5%)	($1,500)	($1,530)	($1,561)	($1,592)	($1,624)
NOI	**$19,800**	**$20,496**	**$21,215**	**$21,957**	**$22,724**
Loan Payment	($16,891)	($16,891)	($16,891)	($16,891)	($16,891)
Debt Service Coverage Ratio	1.17x	1.21x	1.26x	1.30x	1.35x
Net Profit	$2,909	$3,605	$4,324	$5,067	$5,834
Cash-on-Cash Return	**5.55%**	**6.88%**	**8.25%**	**9.67%**	**11.13%**

The cash-on-cash return is one of the most important investment metrics to our most seasoned customers. Why? It shows them the return they are earning on their down payment or the money they had to invest in the property. If the money they have invested or "working" is earning something better than a bank CD or any other investment vehicle that they don't have control over, then odds are, they are going to know whether to hold 'em or fold 'em. In this case, by year 5 the customer is earning 11.13% on the money invested so he may be completely ambivalent about selling the property for a bigger profit return at this point.

Step 3 of 4:

Home Price Appreciation (HPA)

Just as the calculation of your growth rates can give you valuable insight on whether to hold or sell, calculating the appreciation of your SFR rental property will also give you valuable insight as to the profit potential you could realize down the road. And with the average long-term appreciation rate of 3.4%, the profit potential might surprise you.

Calculate Potential Profit Via Property Appreciation Over 5 Years

Appraised Value at Closing	$357,143
Appreciation Rate	3.40%

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Property Value	$357,143	$369,286	$381,841	$394,824	$408,248
EOY Loan Balance	($207,471)	($205,188)	($202,740)	($200,115)	($197,300)
Potential Profit	**$149,672**	**$164,098**	**$179,102**	**$194,709**	**$210,948**

Remember, the value of your SFR rental property is going up as you pay down your loan amount with OPM. Thus, your potential profit is growing every year along with your cash-on-cash return and your net worth!

Step 4 of 4:

Finally, Uncover the Big Picture of a Rental Property's Potential IRR and ROI Over Time.

You have proven your cash-on-cash returns over time. You know the profit potential you could realize at the end of each year during the holding period. Now, calculate the internal rate of return (IRR) and the return on investment of your rental property (ROI).

Estimate Your Return On Investment Over 5 Years

	YEAR 0	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
Down Payment	($52,400)	–	–	–	–	–
Net Profit	–	$2,909	$3,605	$4,324	$5,067	$5,834
Cash on Sale						$408,248
Payoff Loan						($197,300)
Cashflows	**($52,400)**	**$2,909**	**$3,605**	**$4,324**	**$5,067**	**$216,782**

Internal Rate of Return (IRR) **37%**

Return on Investment (ROI) **36%**

$$\frac{\text{Net Profit (Investment Gain - Investment Cost)}}{\text{Investment Cost}} = \frac{\$357{,}143 - \$262{,}000}{\$262{,}000} = \frac{\$95{,}143}{\$262{,}000} = \textbf{36\% ROI}$$

Your internal rate of return (IRR) is calculated similarly to your annual cash-on-cash return, except this calculation includes the big profit hit at the end. Your money goes in (your investment) and money comes out each year in terms of net profits and at the end of your investment hold period in the form of cash on sale. After paying off your loan, what did you earn on your money? In this case, 37%. Well done.

Another way to look at it is your return on investment or ROI, which is your investment gain minus your investment cost divided by your investment cost. On this deal, the ROI was 36%, which is close to the IRR of 37%. Those are solid returns no matter how you calculate them.

It's always been a good idea to have rentals in your portfolio.
Apply now or give us a call at **866-441-0223** to get even more insights on how to build wealth through real estate.