**How to buy a rental property**

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# Introduction:

This manual is written as a reference guide for people who are new to real estate investment and want to buy their first rental property. Buying a rental property as a first-time investor is quite challenging. With ever increasing rise in housing prices around central Texas and the rest of the country, it is imperative to understand the pitfalls, caveats and nuances of buying property to make sure that you get the best value out of your investment. Before we dive deep into the details on how to buy a rental property, lets discuss what a mortgage is and who is a mortgage lender

## What is a Mortgage?

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A mortgage is a loan by a bank or other financial institution that a person can use to finance the purchase of a property. Mortgages are different from personal or student loan since the bank uses your house as a collateral, meaning that if you do not make payments on time the bank can repossess your property. A mortgage is typically 15-year or 30-year term.

Figure : Loan

## Type of Mortgages:

There are different kinds of mortgages, including the Federal Housing Administration (FHA) which have the least requirements, the Veterans Administration (VA) Loans which are usually meant for people who have served in the armed forces, US Department of Agriculture (USDA) Loans which are targeted for rural areas and the conventional loans also known as Fannie Mae or Freddie Mac loan which almost everyone is eligible for if they have good credit and low debt to income ratio.

## Who is a Mortgage Lender?

A hand holding a logo

Description automatically generated with medium confidenceA mortgage lender is a bank or a financial institution that offers home loans. A mortgage lender decides how much loan can you apply for and sets the terms, interest rates and repayment schedule. When working with a financial institution for a loan application, you typically submit the application to a loan officer who collects your application and qualifying documents and counsels you on your finances to strengthen your approval chances.

Figure : Mortgage Lender

## Actions before applying for Mortgage:

Now that we know what a mortgage and a mortgage lender is, there are few actions that need to be taken by the investor before even applying for a mortgage.

* The first thing would be arranging a down payment. Typically banks or credit unions who lend the loan for an investment property require 15-20% of the property value as a down payment, i.e. for a property with listed value of $100,000, you will need to put down $15,000 - $20,000 as a down payment. This requirement is especially stringent on buying properties that you would not be using as your primary residence.
* The next thing would be to make sure that you have good credit score. The best way to gauge what your credit score is would be to go to creditkarma.com and look at your credit score estimates. If your score is below 600 or if you have a lot of late payments on your credit card or you have debt in collections, it is important to take care of the credit score first before thinking about investing in real estate. Lenders typically would not approve a loan if your credit score is low.

Graphical user interface, diagram

Description automatically generated with medium confidence

Figure 3 An example of credit score on credit karma website

* If you do not have a good credit score (a score of 700+) or do not have 15-20% down payment saved for a rental property, it usually takes 6 months to a year (depending on your financial situation) of saving and diligently paying off your debts on a regular basis in order to get into a good financial position for buying a rental property.

Another thing to consider (which is nice to have but not mandatory) is to know your way around a toolbox. You can outsource the work and hire a property management company, but that eats into a lot of profit and as such knowing how to do basic repair around a home is a handy thing to know.

With credit score and down payment taken care of, lets dive into the steps of actually acquiring a rental property.

# Instructions:

## Step 1: Have your tax returns in order

Graphical user interface, icon

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Have your two years of tax returns on hand. The lender is going to look at the last two years of your tax return and will give you the loan based on the average of the two-year tax return value.

Figure : Tax returns

## Step 2: Talk to a lender

A hand holding a logo

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Talk to at least three different lenders and submit all your paperwork including bank statements, last three month pay slips and two years of tax returns to get a rough estimate on how much loan can you be approved for. This also allows you to compare the loan options from the different lenders and find the best option.

Figure : Lender

## Step 3: Understand the different types of properties

There are basically five different types of properties: single family homes, condos, townhomes, duplex and apartments.

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### Single family homes:

A single-family home is a property that we usually find in the suburbs, a general characteristic of a single-family home usually involves having a bit of land around the property which may or may not be landscaped by the owner.

Figure :Single family

### A picture containing text Description automatically generatedTownhomes and Condos:

Townhomes and Condominiums (or condos) are usually within a gated community, may share walls and have a HOA (Home Owner’s Association) with usually no land around the property, a single family home may or may not have an HOA, however the HOA fees are usually lower on a single family home than a condo.

Figure :Condos

### Graphical user interface Description automatically generatedDuplex and Apartments:

The duplexes, triplexes and fourplexes are multi-family homes that has two or more units a building – regardless of how those homes are arranged. These building also have separate entrances for each unit. They are quite popular because it allows the owner to live in one unit while renting out all the other units.

Figure :Apartments

## Step 4: See properties

Icon

Description automatically generatedOnce you have a firm understanding of the different properties and you have decided on which kind of property you are going to buy, the next step is to search for those properties. Use an online service such as Zillow or Redfin to find all the different kinds of properties in your price range and in your preferred location.

Figure :See Properties

You can also use a good local realtor to help you guide and find the best property for your price range. A general rule of thumb is to look at least 10 to 20 different properties in person before making a decision on investing in one.

## Step 5: Find cashflow

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In order to understand the cash flow on a property you need to first look at the ownership cost. You need to consider how much money you are putting down, what your mortgage and interest rate is going to be, the maintenance cost and finally the property taxes associated with that investment. You can plug these values in a mortgage calculator to get a sense of how much money you will be paying out of pocket. You then compare it with the approximate rent you will be able to collect from the property to calculate whether the cash flow will be positive or negative.

Figure :Cashflow

Look for a property that can provide a positive cash flow or at least break even. A good way to measure this is to look at rental listings at craigslist or Zillow in the area you are looking to buy in and find what the average rental price is for a property similar to yours.

## Step 6: Make sure the property is in a desirable location

Logo, company name

Description automatically generatedThe golden rule of real estate is **location**. While the definition of a desirable location is quite subjective and depends on an individual’s taste, a good rule of thumb for a desirable location includes tourist destinations (such as 6th street in downtown Austin, TX or Fredericksburg, TX), properties near a beach (such as in Miami, FL) or neighborhoods that are zoned to an excellent public school district

Figure :Location

Properties that should be avoided includes those that are either too close to a freeway or busy street or are right next to a commercial space or an apartment building. It is also important to understand the zoning laws for the property you are going to invest in and any restrictions on the number of individuals who can live in a property.

## Step 7: Make offers

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Make competitive offers but expect to lose out on some properties due to competition. The number one rule while putting offers on properties is to not be emotionally invested into a particular property and only increase your offer if the numbers make sense. Make sure to work with a competent realtor that can provide you historical sales price to compare the numbers against and also be able to negotiate and put forward the best offer.

Figure : Competitive Offer

## Step 8: Inspect the property

Once your offer is accepted, make sure to inspect as many things you possibly can. Also hire a good inspector to come in and inspect your property thoroughly to find any issues with roof, plumbing, electrical wiring, structural damage etc. Find out how much would it cost to fix any issues found during inspection and ask the seller for a credit or price reduction to cover the costs.

Figure :Home inspection

## Step 9: Estimate the closing costs

Diagram, icon

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There are costs such as lenders fees, escrow cost etc. (separate from the down payment) which need to be taken into account before signing the. These are called closing costs and are usually about 1% of the purchase price of the property. So, for a $400,000 property, a rough estimate of closing costs would be $4000 - $5000.

Figure :Closing cost

## Step 10: Decide whether you want to promote it as a short-term rental vs long term

A picture containing shape

Description automatically generatedWith the rise in popularity of Airbnb and VRBO, it has become quite lucrative for investors to rent their properties on Airbnb. Any property that is rented out for anywhere from one night to several weeks would be considered a **short-term rental**, anything longer than that would be considered a long-term rental. A short-term rental property posted on Airbnb or Vrbo allows the owner to list the property for free, be able to screen guests based on their review and also be able to change the rental price based on the market and seasonality.

Figure :Short term

A close-up of a clock

Description automatically generated with medium confidenceA **long-term rental** is any property that is rented out for at least six months to multiple years. A long-term rental strategy is good for someone who wants a truly passive investment and does not want to deal with changing tenants all the time.

Figure :Long term

Typically for a property that is designed for long term rental there is less investment up front as the property is mostly empty and it is up to the tenant to furnish it. Whereas short term rentals are competing with hotels and are expected to have complete furnishing with utensils etc., typically what someone would find in their own home.

## Step 11: Rent out the property

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Description automatically generatedBefore putting out the advertisements for renting the property, make sure to take really good pictures and create a compelling description to entice potential renters. Once you have the pictures and the description, post the property on as many rental property websites as possible including Craigslist, Zillow, Apartments.com and Trulia for long term rentals and Airbnb and VRBO for short term rental.

Figure :Rental property

A benefit of renting out a property on Airbnb or VRBO is that Airbnb vets the renters. You can see a score as well comments from other property owners indicating whether the person was a good guest. Airbnb also insures the property owner up to $1 million dollars and also has a dedicated support that is easily accessible 24x7.

For long term rentals, make sure to screen your tenants before finalizing including confirming their credit score and source of income.

## Step 12 (Optional): Hire a property manager

A picture containing graphical user interface

Description automatically generatedEach individual has its own criteria of how much they want to be involved in the day to day of managing a rental property. If someone wants to make it a truly passive investment with a hands-off approach, hiring a property manager is a good option.

A property manager handle everything that occurs daily on a rental property. He or is she is expected to screen tenants, collect rent, be fully responsible for maintaining the exterior and interior of the property and communicate any issues to the owners in a timely manner.

Figure 18:Property Manager

Usually, property managers charge anywhere from 20-30% of the rental income, therefore it is always prudent to run the numbers and do your own due diligence to make sure that hiring a property manager is the right decision for you.

Troubleshooting:

## Problem 1: You do not have 2 years of consecutive tax returns.

Cause: It is entirely possible that you might not have consecutive two years of tax returns if you are new to United States or you are still in college and make less than the federal minimum requirement to file taxes.

Resolution: Try to file your taxes moving forward and accrue at least two years of tax returns before planning on investing in a rental property

## Problem 2: Your loan was declined even with a good credit score

Cause: A good credit score is an important factor when applying for a loan, but it is not the only factor. The lender also looks at debt to income ratio and chances are that if your debt to income ratio is greater than 36%, your loan application might get declined. The debt to income ratio is calculated as follows:

**(Monthly Recurring Debt Payments) / (Gross Monthly Income) = Debt-to-Income Ratio**

Where monthly recurring debt would be a rent or mortgage payment, child alimony or a minimum payment for a credit card debt. The gross monthly income would be the combined income (including salary + bonus, passive incomes, income from stock dividends etc.) before taxes.

Resolution: Find an alternative source of income or reduce your debt by paying off any credit card debt or student loans before applying for a mortgage.

## Problem 3: There are no properties in your price range

Cause: With the ever-increasing price of housing market, it is possible that you might not be able to find a property in your desired location for your price range. Austin, TX is a good example of a market where houses that used to cost $300,000 in 2018 are now selling for $500,000+

Resolution: Wait and watch is the best strategy. Usually the market tends to swing in both the buyer’s side and in the seller’s side, so waiting for few months and then choosing a property that meets your criteria is the best bet. If you are flexible with the location and property type, you can increase your search radius or look for properties such as condos instead of single-family homes as they are usually priced lower.

## Problem 4: The inspector found lots of problems with the property and the seller refuses to cover the cost.

Cause: In a hot seller’s market where people are willing to give up on inspection, it is entirely possible that the seller would refuse to cover any costs of fixing the issues.

Resolution: If you are not comfortable with the issues or the cost to fix the issues are huge, it is best to back out of the investment. Usually the buyer has an option to back out of a contract within three to four days after inspection.

## Problem 5: I am not sure how to screen the tenants.

Cause: As a first-time buyer, it might feel quite challenging to verify someone’s background or proof of income

Resolution: If you are not sure on how to go about screening a potential tenant, there are plenty of third-party companies that can help you verify and find good tenants. Zillow provides a rental management facility at a small fee. Another example is “SmartMove” from Transunion that provides tenant verification services.