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Property Purchase

Purchase Price

The price of a property you are purchasing.

Market Value

The actual current value of a property.

The market value is not necessarily equal to the purchase price. For example, if you are able to negotiate a discount with the seller, the market value will be higher than the purchase price.

After Repair Value (ARV)

The estimated market value of a property after its rehab is complete. If no repairs are necessary, the after repair value is the same as the current market value.

For BRRRR deals, the ARV is used to calculate the long-term loan amount during the refinance phase.

When flipping a property, the ARV is usually equal to sale price and is used to calculate the total profit from a flip.

Purchase Costs

All costs and fees associated with purchasing a property, sometimes also called closing costs.

Examples include: appraisal fees, property inspection fees, finder's fees and loan points.

Rehab Costs

Expenses that you expect to pay after purchasing a property to improve its condition or perform repairs.

Examples include: new paint, new appliances, new carpet, electrical repairs, landscaping and cleaning.

Total Cash Needed

The total amount of cash or capital you will need to purchase and rehab a property.

With Financing:

Total Cash Needed = Loan Down Payment + Purchase Costs + Rehab Costs

Without Financing:

Total Cash Needed = Purchase Price + Purchase Costs + Rehab Costs

Total Cash Invested

The total amount of capital you have invested in a property.

For most rental properties and flips, this amount will equal to the total cash you have spent to purchase and rehab the property.

For BRRRR deals, this amount will usually be less than initially invested cash, because you will get some cash back after refinancing the property. It is even possible to receive more cash back than what you originally invested, making your total investment $0 or negative.

Rentals and Flips:

Total Cash Invested = Total Cash Needed to Close

BRRRRs:

Total Cash Invested = Invested Cash - (Refinance Loan Amount - Refinance Costs - Purchase Loan Repayment - Holding Costs)

Purchase Criteria

1% Rule (Rental Properties)

A purchase criteria commonly used by real estate investors when analyzing rental properties.

According to this rule, the rent to value ratio (monthly gross rent divided by the purchase price) of a rental property should be 1% or higher.

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Rent to Value >= 1%
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2% Rule (Rental Properties)

A purchase criteria commonly used by real estate investors when analyzing rental properties.

According to this rule, the rent to value ratio (monthly gross rent divided by the purchase price) of a rental property should be 2% or higher.

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Rent to Value >= 2%
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50% Rule (Rental Properties)

A purchase criteria commonly used by real estate investors when analyzing rental properties.

According to this rule, the operating expenses of a rental property should be less than or equal to 50% of its operating income.

$$\text{Operating Expenses} <= \frac{\text{Operating Income}}{2}$$

65% Rule (House Flips)

A purchase criteria commonly used by real estate investors when analyzing flips and rehab projects.

According to this rule, the purchase price of a property you're flipping should be less than or equal to 65% of its after repair value (ARV), minus the rehab costs you expect to have.

$$\text{Purchase Price} <= \text{ARV} * 65\% - \text{Rehab Costs}$$

70% Rule (House Flips)

A purchase criteria commonly used by real estate investors when analyzing flips and rehab projects.

According to this rule, the purchase price of a property you're flipping should be less than or equal to 70% of its after repair value (ARV), minus the rehab costs you expect to have.

$$\text{Purchase Price} <= \text{ARV} * 70\% - \text{Rehab Costs}$$

Financing

Down Payment

If you are using financing to purchase a property, the down payment is the portion of the property's purchase price, and sometimes also the rehab costs, that you need to pay up-front.

The remainder of the required funds will be financed by your lender and will become your starting loan amount.

Loan Amount

If you are using financing to purchase a property, the loan amount will be the portion of the purchase price, and sometimes also the rehab costs, that will be financed and paid by your lender.

The starting loan amount may also include any financed purchase or closing costs, as well as additional upfront mortgage insurance (PMI) fees.

Loan Payments

If you are using financing to purchase a property, the loan payments are the recurring payments you will be required to make to your lender to repay your loan.

For amortizing loans, the loan payments include principal and interest payment portions. They may also include a recurring mortgage insurance (PMI) payment, if required by your lender.

For interest-only loans, the loan payments consist of only the interest payment portion.

For Amortizing Loans:

Loan Payment = Loan Principal + Loan Interest + PMI (Optional)

For Interest Only Loans:

Loan Payment = Loan Interest

Loan Interest

The portion of the loan payment that goes toward paying the interest on a loan.

In many countries, you are able to deduct the loan interest you pay on your income tax return. Check your local tax laws for the applicable loan interest deduction rules.

Mortgage Insurance (PMI)

Some lenders and loan programs require you to pay private mortgage insurance (PMI), which is typically calculated as a percentage of the starting loan amount.

In some cases, it is a one-time upfront payment that gets added to the starting loan amount. Other times it is a recurring payment that is added to your monthly loan payments.

Refinance Costs

All costs and fees associated with refinancing a property, sometimes also called closing costs.

Examples include: appraisal fees, lender fees, recording fees and loan points.

Cash Flow

Gross Rent

The total rent collected from your tenants, before subtracting any operating expenses or accounting for vacancy.

Vacancy Expense

The amount you will lose in a given time period due to vacancy.

While vacancy isn't a direct expense in the sense that you do not pay it to anyone, it will result in a decrease in collected gross rent.

$$\text{Vacancy Expense} = \text{Gross Rent} * \text{Vacancy Allowance}$$

Other Income

Any miscellaneous income you expect to receive from a rental property, other than rent.

Examples include: coin-operated laundry, parking fees and storage rental.

Operating Income

Total income generated by a rental property, less the vacancy expense. It is sometimes also called the effective gross income (EGI).

$$\text{Operating Income} = \text{Gross Rent} - \text{Vacancy Expense} + \text{Other Income}$$

Operating Expenses

All expenses you will have while renting out a property, excluding any loan payments.

Examples include: property taxes, insurance, property management fees, maintenance, capital expenditures and utilities.

Holding Costs

All recurring expenses you will have while rehabbing a property during a house flip.

Examples include: property taxes, insurance, utilities and dumpster rental.

Net Operating Income (NOI)

Net income generated by a rental property.

While NOI takes into account all operating expenses, it does not account for loan payments. It can therefore be used to compare rental properties irrespective of financing terms.

$$\text{NOI} = \text{Operating Income} - \text{Operating Expenses}$$

Cash Flow

The total net amount you will receive from a rental property as income.

Cash flow accounts for all sources of income and all expenses, including loan payments if you are using financing.

With Financing:
Cash Flow = NOI - Loan Payment

Without Financing:
Cash Flow = NOI

Depreciation

Depreciation

In many countries, you are able to deduct the cost of purchasing and rehabbing a property on your income tax return.

Rather than claiming the entire deduction in the year you purchase a property, you are typically required to distribute it over the course of the property's "useful" life span (the depreciation period).

If you do not reside in the United States, check your local tax laws for the applicable depreciation deduction rules.

$$\text{Yearly Depreciation} = \frac{\text{Purchase Price} - \text{Land Value} + \text{Purchase Costs} + \text{Rehab Costs}}{\text{Depreciation Period}}$$

Depreciation Period

The so-called "useful" life span of a property, used when calculating its depreciation tax deduction.

For example, in the United States, the useful life span of most residential properties is typically 27.5 years, while the useful life span of most commercial properties is typically 39 years.

Land Value

The appraised value of the land, excluding any structures or improvements, of a property.

The land value is typically not included when calculating the depreciation tax deduction and is subtracted from the property's purchase price.

Property Sale

Total Equity

The actual portion of a property's market value that you own.

If you are using financing, your initial equity will depend on your loan down payment and the starting loan amount.

Your equity will increase as you pay down your loan and as the property's market value increases.

With Financing:
Total Equity = Market Value - Loan Balance

Without Financing:
Total Equity = Market Value

Selling Costs

All costs and fees associated with selling a property, sometimes also called closing costs.

Examples include: real estate broker commissions, escrow fees, transfer taxes and a home warranty.

Total Profit (Rental Properties)

The total cumulative profit you will receive if you were to sell a rental property that you own.

In addition to the final sale proceeds, the total profit also includes the cumulative cash flow received throughout the property ownership period.

With Financing:
Total Profit = Property Value - Selling Costs - Loan Balance + Cumulative Cash Flow - Total Invested Cash

Without Financing:
Total Profit = Property Value - Selling Costs + Cumulative Cash Flow - Total Invested Cash

Total Profit (House Flips)

The total net amount you will receive as profit from a house flip after selling the property.

With Financing:
Total Profit = ARV - Selling Costs - Loan Repayment - Holding Costs - Total Invested Cash

Without Financing:
Total Profit = ARV - Selling Costs - Holding Costs - Total Invested Cash

Total Profit (Wholesale)

The total net amount you will receive as profit from a wholesale transaction.

Total Profit = Investor Purchase Price - Wholesale Purchase Price - Closing Costs

Investment Returns

Capitalization Rate (Cap Rate)

A rate of return of a rental property based on comparing the yearly net operating income (NOI) to the purchase price or market value.

Since the cap rate does not take into account loan payments, it can be used to compare rental properties irrespective of financing terms.

Using Purchase Price:

$$\text{Cap Rate} = \frac{\text{Yearly NOI}}{\text{Purchase Price}}$$

Using Market Value:

$$\text{Cap Rate} = \frac{\text{Yearly NOI}}{\text{Market Value}}$$

Cash on Cash Return (COC)

A rate of return of a rental property based on comparing the yearly cash flow to the total invested cash.

COC represents the yearly return or yield you will receive on your invested capital.

$$\text{COC} = \frac{\text{Yearly Cash Flow}}{\text{Total Invested Cash}}$$

Return on Equity (ROE)

A rate of return of a rental property based on comparing the yearly cash flow to your total equity in that property.

ROE represents the yearly return you will receive on your total equity at the end of each year.

$$ROE = \frac{\text{Yearly Cash Flow}}{\text{Equity at End of Year}}$$

Return on Investment (ROI)

A rate of return of a real estate transaction based on comparing the total profit from your investment to the total invested cash.

For a rental property, the ROI takes into account the cumulative cash flow, equity accumulation and loan paydown and shows the total cumulative return on your invested capital, if you were to sell the property at a given point in time.

For a flip, the ROI shows the total return on your invested capital after you complete the rehab and sell the property.

Rentals and BRRRRs:

$$ROI = \frac{\text{Total Equity} - \text{Selling Costs} + \text{Cumulative Cash Flow} - \text{Total Invested Cash}}{\text{Total Invested Cash}}$$

Flips:

$$ROI = \frac{\text{Total Profit}}{\text{Total Invested Cash} + \text{Holding Costs}}$$

Internal Rate of Return (IRR)

An average annualized rate of return on your total invested cash, sometimes also called annualized return on investment (ROI).

For a rental property, the IRR takes into account the cumulative cash flow, equity accumulation and loan paydown and shows the annualized return on your invested capital for the entire time you own the property.

Note, that the rental IRR formula is not algebraic. Instead, IRR is calculated by solving the formula below when the net present value equals 0.

For a flip, the IRR is a hypothetical annualized return on your invested capital based on the current flip transaction.

Rentals and BRRRRs:

$$\text{Net Present Value} = \sum \frac{\text{Cash Flow in Current Year}}{(1 + \text{IRR})^{\text{Number of Years}}} = 0$$

Flips:

$$\text{IRR} = \frac{12 * \text{ROI}}{\text{Holding Period}}$$

Financial Ratios

Rent to Value Ratio (RTV, RTP)

A rate of return of a rental property based on comparing the monthly gross rent to the purchase price or market value.

The rent to value ratio, sometimes also called the rent to price ratio, is used by the common 1% Rule and 2% Rule.

At Purchase:

$$\text{Rent to Value} = \frac{\text{Monthly Gross Rent}}{\text{Purchase Price}}$$

Subsequent Years:

$$\text{Rent to Value} = \frac{\text{Monthly Gross Rent}}{\text{Market Value}}$$

Gross Rent Multiplier (GRM)

A rate of return of a rental property based on comparing the purchase price or market value to the yearly gross rent.

The gross rent multiplier shows the number of years it will take for the yearly gross rent to add up to the original purchase price.

At Purchase:

$$GRM = \frac{\text{Purchase Price}}{\text{Yearly Gross Rent}}$$

Subsequent Years:

$$GRM = \frac{\text{Market Value}}{\text{Yearly Gross Rent}}$$

Equity Multiple

A ratio that shows the total rate of return of a rental property based on comparing the total profit from your investment to the total invested cash.

The equity multiple takes into account the cumulative cash flow, equity accumulation and loan paydown and shows the total cumulative return on your invested capital, if you were to sell the property at a given point in time.

The equity multiple is the same as the return on investment (ROI), except expressed as a ratio.

$$\text{Equity Multiple} = \frac{\text{Total Equity} - \text{Selling Costs} + \text{Cumulative Cash Flow}}{\text{Total Invested Cash}}$$

Break-Even Ratio (BER)

A ratio that compares a property's yearly operating expenses and debt service (loan payments) to its yearly gross rent.

The break-even ratio shows the minimum percentage of occupancy needed to cover all operating expenses and debt service obligations for a rental property.

$$\text{BER} = \frac{\text{Yearly Operating Expenses} + \text{Yearly Debt Service}}{\text{Yearly Gross Rent}}$$

Loan to Cost Ratio (LTC)

A ratio between the loan amount and the acquisition costs of a property, consisting of the purchase price and rehab costs, if they are being financed.

The LTC ratio is often used by lenders as an indicator of lending risk when underwriting new loans.

A higher LTC ratio may result in a loan denial, higher interest rates or the addition of mortgage insurance (PMI).

When Not Financing Rehab Costs:

$$\text{LTC} = \frac{\text{Loan Amount}}{\text{Purchase Price}}$$

When Financing Rehab Costs:

$$\text{LTC} = \frac{\text{Loan Amount}}{\text{Purchase Price} + \text{Rehab Costs}}$$

Loan to Value Ratio (LTV)

A ratio between the loan amount and the market value of a property.

The LTV ratio is often used by lenders as an indicator of lending risk when underwriting new loans.

A higher LTV ratio may result in a loan denial, higher interest rates or the addition of mortgage insurance (PMI).

$$\text{LTV} = \frac{\text{Loan Amount}}{\text{Market Value}}$$

Debt Coverage Ratio (DCR, DSCR)

A ratio that compares a property's yearly net operating income (NOI) to its yearly debt service - the total principal and interest payments on the loan.

The debt coverage ratio, sometimes also called the debt service coverage ratio, is often used by lenders to determine loan eligibility.

A debt coverage ratio below 1 indicates that there is not enough cash flow to cover the debt service, and may result in a loan denial.

$$\text{DCR} = \frac{\text{Yearly NOI}}{\text{Yearly Debt Service}}$$

Debt Yield

A ratio that compares a property's yearly net operating income (NOI) to the total loan amount.

The debt yield is often used by lenders to determine loan eligibility, as an indicator of leverage and loan risk.

A lower debt yield indicates higher leverage and therefore higher risk, while a higher debt yield indicates lower leverage and therefore lower risk.

$$\text{Debt Yield} = \frac{\text{Yearly NOI}}{\text{Loan Amount}}$$

Analysis Assumptions

Vacancy Allowance

A percentage of time you expect a rental property to remain vacant.

A property can remain vacant while you are searching for a new tenant or rehabbing it.

For example, if you expect a property to remain vacant for 1 month each year, the vacancy allowance will be 8.3%.

$$\text{Vacancy Allowance} = \frac{\text{Time Vacant}}{\text{Total Time}}$$

Value Appreciation

An annual percentage increase of the market value of a property.

This increase is typically caused by rising real estate prices or inflation.

Income Increase

An annual percentage increase of the operating income generated by a rental property.

This increase is typically caused by rising market rents or inflation.

Expenses Increase

An annual percentage increase of the operating expenses you will have while renting out a property.

This increase is typically caused by inflation.

Holding Period

The amount of time you anticipate it will take to rehab a property, typically expressed in months.

For house flips, this period also includes the time it will take to sell the property. A longer holding period will increase your holding costs and reduce your total profit.

Rehab Cost Overrun

An anticipated percentage increase of the rehab budget beyond the originally planned amount.

This value provides a safety net during a rehab in the case when the actual rehab costs end up being higher than planned.

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