Title:
Increase Your Rental Income Without Increasing Your Rents

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Summary:
Many Investors Lose Money On Their Rental Properties. Sometimes Without Realizing It. See how a new mortgage product can help increase your monthly cash flow without having to increase your rent.

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Article Body:

Many Investors Lose Money On Their Rental Properties. Sometimes Without Realizing It.

Here is a typical rental scenario:

Mortgage payment going out: $1,100 per month. Rent coming in: $1,200 per month. This gives you $100 a month in positive cash flow. Or does it? On paper it looks good, but if you analyze the big picture and take into account your entire cost to own that rental property, you are losing money in a big way. Let’s analyze those costs over a year:

Holding costs. Let’s say it takes three months to find a tenant for your property - $3,300
Spend marketing dollars to attract a tenant: $500.
Termite treatment: $150.
Landlord’s Insurance: $350.
Cleaning the property after the last tenant moved out: $350.
The water heater went out in February and you had to replace it: $400. Total mortgage payments for the year: $13,200. Other costs: $1,750. Total cost of ownership: $14,950

Rental income of 9 months: $10,800. Net loss for the year: $4,150. Now the picture looks very different. Even after your tax deduction of mortgage interest and depreciation, you still lost money.

How do you fix the problem?

The simplest answer of course is to buy right. This could mean putting down 20% so that your mortgage is much lower than the market rent, or it could mean that you need to buy your rental properties at steep discounts. Putting down 20% every time you buy a rental property will obviously limit how many properties you can buy, so the simplest answer here is the second option of paying less for the property.

The 4 Biggest Reasons For Negative Cash Flow Investment Properties

1. You paid too much for the property. If your mortgage is not significantly less than the rent coming in, (and I mean several hundred dollars a month less), then you paid too much for the property.
2. You overestimated the rents you can get for your area.
3. The price you paid for the property was too high
4. You should have paid less for the property

If your problem is that you paid too much for the property, then the rents in your area of course will not be high enough, and if you overestimated the rents on top of paying too much, you better have deep pockets or you are going to face foreclosure. Short of selling the property immediately, you can:

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I am going to give you a financing strategy here that can let you cash flow hundreds of dollars per month. But. Like everything else that sounds too good to be true, it has a downside. There is a relatively new mortgage product on the market (Been around for about 6 years), called an Option ARM. It gives you 4 different ways you can pay it every month:

Pick a payment similar to a 15 year mortgage (build equity fast)
Pick a payment similar to a 30 year mortgage (build equity slow)
Pick a interest only payment (build no equity) OR
Pick the minimum payment (accrue negative equity)

The minimum payment in option 4 can be as low as 1.5% (calculated like a fully amortized 30 year fixed payment). If you choose to pay the minimum payment, your payment in the scenario of this discussion will be $520 per month instead of $1,100 per month (I’m assuming that taxes and insurance are escrowed). Now if your rent is $1,200 per month, you have a positive cash flow of $680 a month on the same property with the same tenant and you never increased the rent. Well, that feels a little better doesn’t it?

That may feel good, but here is the gotcha: Your minimum payment is less than your interest only payment. Since banks are not in the business of losing money, they will still calculate the full interest only payment for that month, they will just be happy to accept your minimum payment. So happy in fact, that they will take the difference between your minimum payment and the interest only payment, and add it to the outstanding loan balance. So now you owe them more than last month. Ouch.

But wait, that may not be so bad. Why?

You can still pay it like a 30 year or 15 year mortgage and only use the minimum payment when you have a vacancy. It will reduce the pain in your wallet when you have to spend money for marketing in addition to making the payment on that vacant property.

This is an okay reason for getting an option ARM. But not a great reason. Why? Because the rate (not the minimum payment which is fixed for a year), will typically adjust monthly based on the index it is tied to. If rates are trending down, this mortgage is unbelievable. Every month you have to pay less since the interest only payment is going down, and you have the choice of the minimum payment in addition to that. If rates are trending up, then every month your interest only payment will be going up (while your minimum payment is fixed for a year). When this happens, this is no fun. By the way, as of May 2006 the market is trending up.

Since this mortgage can make me cash flow very well every month, but also has a downside, in which particular situation should I use it?

Great question. This is the question you should ask on every mortgage you ever get on an investment property. I would recommend this loan very strongly under the following scenario: Your goal is to sell the property in the next two years or less, and you will owe no more than 80% of the appraised value of the property on this loan (90% is okay if you are going to sell in one year or less). This is the perfect fit for this loan program. Here is why:

You can make the minimum payment every month and enjoy the maximum cash flow right now. You will incur negative equity, but since your loan to value is fairly low, it will not make much of a difference over a one or two year period. You will have roughly $460 per month of negative equity for a total of $5,520 after one year, or $11,040 in two years (Not totally accurate, as your minimum payment will go up by 7.5% of the PAYMENT, not interest rate, once a year. But close enough for our illustration here.)

That may sound high, but here is the hidden benefit: that negative equity is deferred interest. When you sell the property after one or two years, you can take that accumulated deferred interest as a tax write off in the year that you sell the property (check with your CPA on this since I am not a tax expert and I do not give tax advice). Since you can time this sale to a certain degree, you can use this deferred interest deduction to reduce your total tax bill should you have a windfall profit on another transaction in the same year. In other words, use the deferred interest deduction to offset the gain in another area.

Remember also that you always have the choice of making the full interest only payment - you don’t have to incur the negative equity if you do not want to. The beauty of this mortgage is that it gives you options. Cash flow when you need it most, but still reducing your balance if you want to.

The absolutely perfect fit is if you have a high equity situation and are selling on a lease purchase. That way you can enjoy the positive cash flow now, and still get a good profit on the sale. Many investors don’t make money on a lease purchase during the lease period. They only make money when the sale happens. In the time between you still have to put gas in your tank and provide for the family though, and you need cash to do that. Let’s see how the math works:

You bought a rehab with hard money, fixed it up, and refinanced into an Option ARM. You choose to sell on lease purchase so that the sale will take place at least a year since when you bought the property, so that you will reduce your capital gains tax by half, and so the property will season for mortgage purposes. Since you have to feed your family in the meantime, you get $680 cash a month in your pocket while you wait for the big paycheck.

Now multiply this by 5 properties using the above scenario. Five times $680 is $3,400 a month of positive cash flow. Can you do with a little extra cash while you wait on the big paycheck when you sell?