15 Tips for Buying Your First Rental Property

Consider the risks and rewards of owning investment property

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Thinking about purchasing an investment property? Real estate has produced many of the world's wealthiest people, so there are plenty of reasons to think that it is a sound investment. Experts agree, however, that as with any investment, [it's better to be well-versed](https://www.investopedia.com/articles/06/rentalrealestate.asp) before diving in with hundreds of thousands of dollars. Here are the things you should consider and investigate.

KEY TAKEAWAYS

* Purchasing an investment property to earn rental income can be risky.
* Buyers will usually need to secure at least a 20% downpayment.
* Being a landlord requires a broad array of skills, which could be as diverse as understanding basic tenant law to being able to fix a leaky faucet.
* Experts recommend having a financial cushion, in case you don't rent out the property, or if the rental income doesn't cover the mortgage.

1. Are You Cut out to Be a Landlord?

Do you know your way around a toolbox? How are you at repairing drywall or unclogging a toilet? Sure, you could call somebody to do it for you or your could hire a property manager, but that will eat into your profits. Property owners who have one or two homes often do [their own repairs to save money](https://www.investopedia.com/articles/mortgages-real-estate/09/so-you-wanna-be-a-landlord.asp).

Of course, that changes as you add more properties to your portfolio. Lawrence Pereira, president of King Harbor Wealth Management in Redondo Beach, Calif., lives on the West Coast but owns properties on the East Coast. As someone who says he's not at all handy, he makes it work. How? "I put together a solid team of cleaners, handymen, and contractors," says Pereira.1﻿

This isn't advisable for new investors, but as you get the hang of real estate investing you don't need to remain local.

If you're not the handy type and don't have lots of spare cash, being a landlord may not be right for you.

2. Pay Down Personal Debt

Savvy investors might carry debt as part of their [portfolio investment strategy](https://www.investopedia.com/terms/i/investmentstrategy.asp), but the average person should avoid it. If you have student loans, unpaid medical bills, or children who will attend college soon, then purchasing a rental property may not be the right move.

Pereira agrees that being cautious is key, saying, "It's not necessary to pay down debt if your return from your real estate is greater than the cost of debt. That is the calculation you need to make." Pereira suggests having a cash cushion. "Don't put yourself in a position where you lack the cash to make payments on your debt. Always have a margin of safety."1﻿

3. Secure a Downpayment

Investment properties generally require a larger downpayment than do owner-occupied properties; they have more stringent approval requirements. The 3% you may have put down on the home where you currently live isn't going to work for an investment property. You will need at least a [20% downpayment](https://www.investopedia.com/personal-finance/how-long-should-it-take-save-down-payment/), given that mortgage insurance isn't available on rental properties. You may be able to obtain the downpayment through bank financing, such as a [personal loan](https://www.investopedia.com/articles/personal-finance/111815/6-biggest-banks-offering-personal-loans.asp).

4. Find the Right Location

The last thing you want is to be stuck with a rental property in an area that is declining rather than stable or picking up steam. A city or locale where the population is growing and a revitalization plan is underway represents a potential investment opportunity.

[When choosing a profitable rental property](https://www.investopedia.com/articles/mortgages-real-estate/08/buy-rental-property.asp), look for a location with low property taxes, a decent school district, and plenty of amenities, such as parks, malls, restaurants, and movie theaters. In addition, a neighborhood with low crime rates, access to public transportation, and a growing job market may mean a larger pool of potential renters.

5. Should You Buy or Finance?

Is it better to buy with cash or to finance your investment property? That depends on your investing goals. Paying cash can help generate positive monthly cash flow. Take a rental property that costs $100,000 to buy. With rental income, taxes, [depreciation](https://www.investopedia.com/terms/d/depreciation.asp), and income tax, the cash buyer could see $9,500 in annual earnings, or a 9.5% annual return on the $100,000 investment..

On the other hand, financing can give you a greater return. For an investor who puts down 20% on a house, with compounding at 4% on the mortgage, after taking out operating expenses and additional interest, the earnings add up to roughly $5,580 per year. Cash flow is lower for the investor, but a 27.9% annual return on the $20,000 investment is much higher than the 9.5% earned by the cash buyer.

6. Beware of High Interest Rates

The cost of borrowing money might be relatively cheap in 2020, but the interest rate on an investment property is generally higher than a traditional mortgage interest rate. If you do decide to finance your purchase, you need a low mortgage payment that won't eat into your monthly profits too much.

Mortgage lending discrimination is illegal. [If you think you've been discriminated against](https://www.investopedia.com/housing-discrimination-what-can-you-do-5074478) based on race, religion, sex, marital status, use of public assistance, national origin, disability, or age, there are steps you can take. One such step is to file a report to the [Consumer Financial Protection Bureau](https://www.consumerfinance.gov/complaint/) or with the [U.S. Department of Housing and Urban Development](https://www.hud.gov/faqs/complaints) (HUD).

7. Calculate Your Margins

Wall Street firms that buy distressed properties aim for returns of 5% to 7% because, among other expenses, they need to pay staff. Individuals should set a goal of a 10% return. Estimate maintenance costs at 1% of the property value annually. Other costs include homeowners' insurance, possible homeowners' association fees, property taxes, monthly expenses such as pest control, and landscaping, along with regular maintenance expenses for repairs.

8. Invest in Landlord Insurance

Protect your new investment: In addition to homeowners insurance, consider purchasing [landlord insurance](https://www.investopedia.com/articles/personal-finance/061515/quick-guide-landlord-insurance.asp). This type of insurance generally covers property damage, lost rental income, and liability protection2﻿﻿—in case a tenant or a visitor suffers injury as a result of property maintenance issues.

To lower your costs, investigate whether an insurance provider will let you bundle landlord insurance with a homeowner's insurance policy.

9. Factor in Unexpected Costs

It's not just maintenance and upkeep costs that will eat into your rental income. There's always the potential for an emergency to crop up—roof damage from a hurricane, for instance, or burst pipes that destroy a kitchen floor. Plan to set aside 20% to 30% of your rental income for these types of costs so you have a fund to pay for timely repairs.

10. Avoid a Fixer-Upper

It's tempting to look for the house that you can get at a bargain and flip into a rental property. However, if this is your first property, that's probably a bad idea. Unless you have a contractor who does quality work on the cheap—or you're skilled at large-scale home improvements—you likely would pay too much to renovate. Instead, look for a home that is priced below the market and needs only minor repairs.

11. Calculate Operating Expenses

[Operating expenses](https://www.investopedia.com/terms/o/operating_expense.asp) on your new property will be between 35% and 80% of your gross [operating income](https://www.investopedia.com/terms/o/operatingincome.asp). If you charge $1,500 for rent and your expenses come in at $600 per month, you're at 40% for operating expenses. For an even easier calculation, use the 50% rule. If the rent you charge is $2,000 per month, expect to pay $1,000 in total expenses.

12. Determine Your Return

For every dollar that you invest, what is your return on that dollar? Stocks may offer a 7.5% [cash-on-cash return](https://www.investopedia.com/terms/c/cashoncashreturn.asp), while bonds may pay 4.5%. A 6% return in your first year as a landlord is considered healthy, especially because that number should rise over time.

13. Buy a Low-Cost Home

The more expensive the home, the greater your ongoing expenses will be. Some experts recommend starting with a $150,000 home in an up-and-coming neighborhood. In addition, experts advise never to buy the nicest house for sale on the block, ditto for the worst house on the block.

14. Know Your Legal Obligations

Rental owners need to be familiar with the landlord-tenant laws in their state and locale. It's important to understand, for example, your tenants' rights and your obligations regarding security deposits, lease requirements, eviction rules, fair housing, and more in order to avoid legal hassles.

15. Weigh the Risks vs. the Rewards

In every financial decision, you must determine if the payoff is worth the potential risks involved. Does investing in real estate still make sense for you?

Risks

* Although rental income is [passive](https://www.investopedia.com/terms/p/passiveincome.asp), tenants can be a pain to deal with unless you use a property management company.
* If your [adjusted gross income](https://www.investopedia.com/terms/a/agi.asp) (AGI) is more than $200,000 (single) or $250,000 (married filing jointly), then you may be subject to a 3.8% surtax on net investment income, including rental income.﻿﻿
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* Rental income may not cover your total mortgage payment.
* Unlike stocks, you can't instantly sell real estate if the markets go sour or you need cash.
* Entry and exit costs can be high.
* If you don’t have a tenant, you still need to pay all the expenses.

Rewards

* Because your income is passive, notwithstandng the initial investment and upkeep costs, you can earn money while putting most of your time and energy into your regular job.
* If real estate values increase, your investment also will rise in value.
* You can put real estate into a [self-directed IRA](https://www.investopedia.com/terms/s/self-directed-ira.asp) (SDIRA) .
* Rental income is not included as part of your income that's subject to Social Security tax.
* The interest you pay on an investment property loan is tax-deductible.
* Short of another crisis, real estate values are generally more stable than the stock market.
* Unlike investing in stocks or other financial products that you cannot see or touch, real estate is a tangble physical asset.

A Final Word

Be realistic in your expectations. As with any investment, rental property isn't going to produce a large monthly paycheck right away, and picking the wrong property could be a catastrophic mistake.

For your first rental property, consider working with an experienced partner. Or, rent out your own home for a period to test your proclivity for being a landlord.