How Much Profit Should You Make on a Rental Property?

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[Real estate](https://www.biggerpockets.com/rei/glossary/real-estate?itm_source=ibl&itm_medium=auto&itm_campaign=glossary) will likely be one of the largest investments in your portfolio. High risk can lead to high reward—but only if you put in the time and research to understand your market and the numbers behind your investment. Good investments require analysis, and you should have a solid understanding going into any real estate deal of what you can expect from your investment's return.

Setting unrealistic expectations for your [return on investment](https://www.biggerpockets.com/rei/glossary/return-on-investment-roi?itm_source=ibl&itm_medium=auto&itm_campaign=glossary) (ROI) can set you up for failure and hurt your profit. Most real estate investment strategies tie up large chunks of money for quite some time, so you need to weigh the pros and cons between committing for the long haul or finding a property to flip.

Setting realistic expectations for property value and cash flow will ensure your investment turns out to be a great deal.

How to Determine Profitability of Real Estate Investments

There are several commonly used methods to calculate the return on your real estate investment and help you keep your property profitable over time.

Return on Investment (ROI)

Many experts and successful investors consider ROI to be the most crucial factor to consider when it comes to evaluating the profitability of a real estate investment. There is no across-the-board number for a “good” ROI, but on average, it is recommended to aim for an ROI above 15%. You have to consider factors like your investment goal, property location, and size.

Here’s an example. You purchase a rental property for $400,000 and pay an additional $20,000 in closing fees and maintenance/repair costs. When the property is ready to hit the market, you charge your tenants $2,500 per month.

If you divide your income by your expenses, your yearly ROI would be just over 7%. Whether 7% is a “good” or “bad” number is completely dependent on your specific financial situation and the property in which you’ve chosen to invest.

Cash-on-Cash Return

[Cash-on-cash return](https://www.biggerpockets.com/blog/cash-on-cash-return?itm_source=ibl&itm_medium=auto&itm_campaign=opt) (CoC) is a widely used metric for calculating real estate investment profitability. It measures the yearly return on an investment based on cash invested and net operating income. CoC will vary greatly depending on your financing method, such as whether you bought a property with cash instead of using a [loan](https://www.biggerpockets.com/home-loans). According to most experts, aim for a CoC that yields between 8% and 12%.

*Related:*[*Cap Rate and Cash-on-Cash Return: A Definitive Guide*](https://www.biggerpockets.com/blog/2014-05-10-cap-rates-cash-cash-returns-explained)

Capitalization Rate

In real estate, capitalization rate (aka [cap rate](https://www.biggerpockets.com/rei/glossary/capitalization-rate-aka-cap-rate?itm_source=ibl&itm_medium=auto&itm_campaign=glossary)) is the ratio of net income to the purchase price of the property. For example, a $200,000 property that you rent for $1,500 per month would lead to a net operating income of $12,000 each year. This equates to a capitalization rate of 6%.

A successful cap rate depends on a variety of factors. In a less desirable neighborhood with risks or safety concerns, 6% might not be worthwhile. But in a high-demand neighborhood with reliable tenants, 6% might be a great return.

The 1% Rule

This is a quick and easy tool to help investors evaluate the potential of a property. The 1% rule says that the amount grossed through monthly rent should be at least 1% of the final property purchase price.

For example, a $300,000 property should rent for at least $3,000 per month. If this doesn’t match market prices or seems unreasonable, the investment likely isn’t worth it. Again, factors like property size and location need to be taken into account.

Assessing Whether a Rental Property Is a Good Investment: Factors To Consider

While real estate investment has significant benefits, that doesn’t mean you won’t face hardships and challenges along the way. Having a solid understanding of your financial situation and the potential of the property you’re interested in is crucial, but you’ll also need to consider the unexpected expenses that are likely to arise.

Will you take care of the property yourself and manage any tenants? How will you prepare for an emergency repair like a burst pipe or leaky roof? What are your long-term financial goals? All of these questions will ultimately impact the profitability of your real estate investment.

Here are a few other factors to keep in mind when evaluating an investment opportunity:

* Initial investment: How much money will you be putting up and for how long? An amazing ROI might not be worth it if you’re spending every penny of your savings to purchase the home, leaving no room for error.
* Property condition: If the property is going to need significant repairs or updates in the near future, calculate these costs into the purchase price of the home.
* Rent-to-mortgage ratio: If you're investing in a rental property, do the math to make sure the numbers have you coming out on top. If the expected rent payment is not going to cover your [mortgage](https://www.biggerpockets.com/rei/glossary/mortgage?itm_source=ibl&itm_medium=auto&itm_campaign=glossary), insurance, taxes, and association dues, then it's not a good investment.
* Property location: You can change a lot of things about a property, but you can’t change the neighborhood it’s located in. Even the nicest house in the worst neighborhood might not turn out to be a profitable investment.

Any investment is about weighing the risks versus rewards, and investing in real estate is no exception. Do your homework and understand the numbers. If the numbers don’t make sense, it’s time to walk away and look for the next opportunity.