

Investors' Essentials

As an investor, or someone thinking about investing in real estate, your ultimate goal is to own a property or properties that provide you with a positive cash flow. It is useful for beginning investors to familiarize themselves with some basic concepts to aid in their comprehension of investment strategies. There are two basic ways to invest in real estate. You can buy a property, fix it up and sell it for a profit. The other way is to generate rental income from tenants.

Regardless of your preferred type of investment, there are basically three types of property in which you can invest.

1. Single-family dwelling
2. Residential income property (2 or more units)
3. Commercial property

If you are purchasing a single-family dwelling, simply project the income, subtract costs (including maintenance and allowing for vacancy, often estimated at 5%) and you will be able to tell how much income this property should generate.

When attempting to generate rental income from a residential income or commercial property, it is useful to use a cap rate, or capitalization rate, to decide if purchasing a property is in your best interests.

Start with the actual (or projected) rental income generated by a property. Next, account for vacancies (typically estimated at %). Finally, deduct expenses (taxes, insurance, maintenance, utilities, property management and so forth). Subtract this amount from the income generated and you arrive at your Net Operating Income, or NOI.

In other words, Money coming In — Money Going Out = NOI.

Prior to deciding to purchase property, many investors have established an acceptable return percentage (for example, 10%). Anything lower and they won't purchase the property. Therefore, after determining your annual NOI, use this as 10% (or your acceptable return percentage of your top purchase price).

For example, say a residential income property generates \$60,000 annually, with \$23,000 in expenses (vacancies, etc.). That leaves an NOI of \$37,000. The cap rate is expressed as a percentage, or 10% return. With an NOI of \$37,000, the cap rate limits the purchase price to \$370,000 or less.