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A Beginner's Guide to Buying Rental Property

If you're lucky enough to own one home and have cash to spare, you may consider buying rental property. After all, collecting rent from tenants every month can be a nice way to pad your pocketbook and dip a toe into the world of real estate investment. But as the saying goes, with great reward comes great risk. Here's everything you need to know about the process before starting your search.

Research the rental property market

Before purchasing a rental, do a deep dive of research into the market where you'd like to buy (realtor.com® can help point you to all kinds of properties). First-timers should probably start with their own area of residence, suggests real estate trainer Dean Graziosi.

You should know the major employers, what drives people to move there, and the economic outlook for at least the foreseeable future, he notes.

You should also watch out for your own financial future. Maybe you can justify stretching your budget for your primary home, but when you're looking at investment property, every cent matters. Don't dig into your savings just because you like the backyard—now is not the time to let flights of fancy take hold. Remember, this is a money-making venture, not a place you will live yourself, so your own personal preferences should take a back seat to what makes good ol' dollars and cents.

Figure out your cash flow and costs

Working out the cash flow of a rental property isn't just a simple equation of rent > mortgage. You also need to consider the other operating expenses, like HOA fees, taxes, repairs, and property management fees. Will you be paying for utilities, or will that be the tenant's responsibility? Keep in mind your new rental property may not be occupied 100% of the time—and that needs to be factored into your business plan, too.

This is called determining the capitalization rate (or “cap rate” for short), which “estimates the net stabilized return on an investment, in comparison to projected income from alternative investments,” says Alex Cohen, a commercial specialist with CORE in New York City. Translation: This can help you decide between good, great, and terrible deals.

Find financing for your rental property

Most banks require at least 20% down for an investment property, especially if you own multiple rentals. Even if you’re able to buy with a lower down payment, think long and hard before purchasing a rental property without much money down. With so many variables in play, from potentially unreliable tenants to a broken dishwasher needing immediate repair, you need a strong financial base before investing. (You can find out how much house you can afford with the realtor.com mortgage calculator.)

However, there is a mortgage bonus when purchasing a rental: Your bank may consider the potential income stream from this property when determining how much you can borrow. This can allow you to purchase a larger or nicer home, since the odds are good that your rental revenue will help you foot the bill.

Managing the rental property

Once you’ve purchased your rental property, you’re ready for tenants! Next, do you want to be a landlord or hire someone to manage your investment? Newbie investment owners should consider a property manager, who will handle all the annoying nitty-gritty details of owning a rental property. For a fee, a third party will draw up leases, collect rent, deal with maintenance issues, and take over the nasty parts—like evictions.

Before choosing a property management company, be sure to do your research. Get (and contact) references. An excellent manager makes owning rental property a breeze, but with a bad egg, it could be a nightmare, turning your rental property into a terrible investment.