Rental Property Evaluation & Underwriting Playbook

Deal Due Diligence: Cash Flow, Cap Rate, Cash-on-Cash Return, 1% Rule & DSCR.

1. CORE UNDERWRITING FORMULAS & BENCHMARK HURDLES

*** Cash-on-Cash Return (CoC) = Annual Net Cash Flow / Total Cash Invested:**
Target 8% to 12%+ for long-term residential rentals. Measures actual cash yield on the out-of-pocket cash deployed (Down Payment + Closing Costs + Initial Rehab).

*** Capitalization Rate (Cap Rate) = Annual Net Operating Income (NOI) / Purchase Price:**
Evaluates the property unleveraged yield independent of financing. Compares pricing across markets; residential targets range from 5.5% to 8.0%+.

*** The 1% Rule & Gross Rent Multiplier (GRM) Screening Tests:**
Gross monthly rent should approach ~1% of acquisition price ($3,000/mo on $300k). GRM (Purchase Price / Annual Gross Rent) should ideally sit between 6x and 10x.

2. REALISTIC OPERATING EXPENSES & RESERVE PROTOCOL

*** The 50% Operating Expense Benchmark:**
Expect 40% to 50% of gross rental income to be consumed by non-mortgage operating costs: property taxes, hazard insurance, vacancy, maintenance, CapEx, and management.

*** Capital Expenditure (CapEx) Reserve Allocation:**
Budget 5% to 10% of monthly rent into a dedicated sinking fund for long-term mechanical replacements (roof, HVAC, water heater) rather than treating gross cash flow as profit.

*** Debt Service Coverage Ratio (DSCR) Safety Floor:**
Lenders and prudent investors require DSCR = Net Operating Income / Annual Debt Service >= 1.25x. A ratio below 1.15x signals elevated default risk during tenant turnover.

3. 5-STEP RENTAL PROPERTY UNDERWRITING & PURCHASE CHECKLIST

- [ ] **Verify Real Operating Taxes & Insurance Reassessments**

  Do not rely on the seller historical property tax bill. County tax assessments reset upon sale to the new purchase price, often increasing annual tax liability by 20% to 50% in appreciating jurisdictions.

- [ ] **Stress-Test Vacancy with Local Rental Sub-Market Comps**

  Underwrite at least an 8% vacancy allowance (1 month empty per year). Check active Craigslist, Zillow, and Rentometer inventory to verify market absorption times.

- [ ] **Budget Professional Property Management (8% to 10%)**

  Always underwrite full property management fees even if self-managing. If a deal only works with unpaid owner labor, it is an underperforming investment.

- [ ] **Calculate Cash-on-Cash Opportunity Cost vs. Index Funds**

  Compare projected year-1 CoC return against guaranteed safe cash yields (~4.5%) and broad market index returns (VOO ~9.5%). Ensure real estate illiquidity offers adequate risk compensation.

- [ ] **Verify Financing Terms & Interest Rate Lock Horizons**

  Confirm investment property loan terms (typically 20% to 25% down payment with interest rates 0.50% to 1.00% higher than primary residential mortgages).