How To Calculate ROI in Real Estate

Your Ultimate Guide

BUYPROPERLY

For more visit BuyProperly.ca

For more visit BUYPROPERLY.CA

Our Story• Our Team • Expert Advisors • Properties • Contact Us • FAQs • Events
Blog • Sign Up • Privacy Policy • Terms Of Use •Risks & Disclosure •Download Our App

1 Introduction paragraph:

If you've dabbled in real estate investing (or even if you're brand new) you've undoubtedly heard of ROI and how important it is to consider when making your investment decisions.

But what exactly is it, and how do you calculate ROI in real estate? Is it crucial for investment success?

We're going to break down the basics of ROI, how to calculate it, and how to use it to make smart investment decisions so you can grow your real estate portfolio with confidence.

Ready? Let's dive in!

2 What is ROI?

ROI stands for “return on investment” and it’s a very important concept to understand when it comes to real estate investing.

It is a standard metric used to calculate the profitability of an investment on a case- by-case basis. It measures the financial return of a particular investment relative to its cost. The higher the ROI, the more profitable the investment and (presumably) the better it is.

2.1 Why is ROI so popular for measuring profitability?

Two reasons: first, it’s incredibly simple to understand and easy to calculate the ROI on almost any investment.

Second, it provides a simple way to get a financial “snapshot” of an investment relative to other investments so you know when to buy, sell, or simply measure whether or not your portfolio is on the right track.

Although it’s incredibly important to know the ROI of any investment, it often doesn’t take into account the complexities, nuances, and “life factors” involved in growing a successful real estate portfolio. For this reason, it should be used as a tool to give broad feedback on the quality of your investments.

2.2 Why is ROI in real estate so important?

Although many ROI formulas paint a simplistic picture of investing, they can also give a very quick and solid overview of a property’s profitability.

In a pinch, you can figure out the “health score” of any potential investment you’re interested in and weed out some of the bad apples along the way. Properties with an obvious cash flow issue or negative ROI can be identified quickly.

When taken into account with your overall investment goals, using ROI calculations will help you make smart financial decisions and build a solid real estate portfolio.

Here at BuyProperly, we calculate ROI for our investors and use it as a benchmark to measure the profitability of our properties. Most of our investors can expect to see projected annual returns of 10-40%!

3 The formula for calculating ROI

There are a few different ways to calculate ROI depending on the type of real estate investment you have. Let's look at how to calculate ROI for real estate investments that are resales OR rental investments.

Let's look at some examples.

3.1 Resales

When calculating the profitability of resale real estate investments, there is a simple formula:

Your equity in the property (total gains minus your total costs) divided by total costs

There are 2 methods real estate investors can use to calculate their gains and costs: the Cost Method and the Out-of-Pock Method. Let's look at them both in detail.

3.1.1 Cost Method

This method for calculating ROI uses the total equity in a property divided by that property's costs (renovations, repairs, and sale price). The Cost Method works for properties purchased with both cash and/or financing.

As an example, say you purchase a home for $250,000. After putting in an additional

$100,000 for repairs, you sell the property for $500,000.

First, you need to calculate your equity in the property. If it sold for $500,000 after your total costs were $350,000 for the purchase and repairs, you had $150,000 left of equity.

Next, calculate the total costs. As mentioned above, the total costs for the property were $350,000 ($250,000 purchase price plus $100,000 in repairs).

After you divide your equity ($150,000) by the total costs ($350,000), you get 0.43 which is a 43% ROI.

3.1.2 Out-of-Pocket Method

The second popular method for calculating ROI looks at only what you've spent out- of-pocket for property costs and expenses and doesn't take into account the property financing.

When would investors use this method? The Out-of-Pocket Method can be used to calculate ROI only when investors purchase a property with a mortgage. Both the down payment and financing on the property are calculated as equity, making the overall ROI higher.

Let us discuss the same example as above.

You purchased the property for $250,000 and put $100,000 of repairs, only this time, let's say you put a 20% down payment on the house and used a traditional mortgage to finance the rest.

This means your out-of-pocket expenses are only $50,000 (your down payment) plus $100,000 (repair costs).

If the property is worth $500,000 after repairs, this means you have $350,000 of equity (including you bank financing as leverage). After you divide $350,000 by the total sale price ($500,000) you're left with a 70% ROI.

3.2 Rental properties

Calculating ROI on rental properties is slightly more complex since we need to factor in year-over-year profitability.

For this ROI, we use the following formula:

Net operating income (annual rental income - operating expenses) divided by the total mortgage value.

Using the example from above, if you purchased your property for $250,000 with a 20% down payment, that means your mortgage is $200,000.

Now, let's say your monthly rent is $1200. Multiply this by 12 to get the average yearly rent. Subtract operating expenses (let's assume these are $500 a month). This leaves you with a yearly net operating income of $8400.

Divide $8400 by the current mortgage value ($200,000) and you're left with an ROI of 4.2% per year. Keep in mind, as the mortgage value decreases over time, the ROI increases.

4 What is a good ROI for real estate?

Determining a “good ROI” for real estate investments very much depends on your personal goals and ability to tolerate risk which means there’s no right or wrong answer.

Investors looking to rent will normally be content with lower yearly ROI numbers knowing they plan on holding the property as a long-term investment. For rental properties, it’s common to expect a 5-10% ROI.

Property flippers on the other hand are more interested in the immediate ROI and are looking for something with the potential to generate higher returns. In this case, an ROI of 20% or above is ideal.

Here at BuyProperly, we help real estate investors get started for as little as $2500 and see projected annual returns of 10-40%!

5 Conclusion

ROI is an important consideration when investing in a property. Whether you're looking for a quick return or long-term cash flow and appreciation, calculating ROI can help make your next investment decision easier.

Remember, since ROI is a simplistic method of sizing up your next real estate investment, it's important to analyze it alongside your risk tolerance profile, as well as your long-term and short-term goals before making any investment decisions.

Looking to get started in real estate investing without the overwhelm? Check out our properties and see how we use a fractional ownership model to help investors build their real estate portfolios.

See top investment properties