3 Things to Consider Before Investing in Rental Properties

[Editor's Note: This is a republished post from Passive Income MD (PIMD), a member of The White Coat Investor Network. If you think investing in a rental property is for you, carefully consider these points from PIMD. I would just add one more thing to his first point, make sure you are also maxing out your tax-deferred retirement space before investing in real estate. This is how we invest in real estate. The original post ran here, but if you missed it the first time, it's new to you! Enjoy!]

If you've ever thought about investing for passive income, you've probably already considered investing in real estate. Just about anyone currently investing in this asset class will tell you it's a good idea – and with good reason. Like me, many of you probably know doctors who have been quite successful in this area, and maybe you're thinking it's time you hopped on the wagon.

I first caught the real estate bug several years ago, and it has catapulted me toward my ultimate goal of financial freedom. Now that I have some experience, I'm often asked how to start investing. Real estate investments have been greatly beneficial to me, but before I recommend to folks that they should invest, I make sure that they consider the following three points. Before you decide that investing in rental property is for you, carefully consider them for yourself.

1. Make Sure Your Finances Can Handle it

This type of long-term commitment can take its toll on your finances if you’re not well prepared. Investing in a rental property is not a quick in and out situation (unless you’re looking to do a quick flip). For our purposes, it’s best to be thought of as a long-term play.

Make sure all your expenses are well covered, that you have a decent emergency fund, and that the money you’re investing is surplus money you won’t need for awhile. Do you have some expected large spends like college for your children or trying to buy your own home? If so, perhaps this isn’t the time to lock up a large number of funds in an investment.

It’s also critical that you prepare a maintenance fund for both expected and unexpected expenses that come with a rental property. This might include a new roof, water heater, or HVAC system that could end up being a relatively significant cost. Any smart landlord will set aside an amount (~5%) for these capital expenses, also referred to as CapEx.

Again, realize that you can make in the short term by flipping the home, which means you buy and sell in a short period of time. However, for the most part, that’s extremely dependent on the way the housing market is moving. So if you know you need access to these funds in a short period of time, perhaps move on.

2. Decide If You Want to Be a Landlord

Readers of this blog know that I firmly believe that owning real estate is one of the best (if not *the* best) paths to sustained long-term wealth creation. It can be a great passive income stream. However, it's not without its headaches. When it comes down to it, being a landlord means dealing with people and all the ups and downs that go along with it.

Don't want to be surprised with a clogged toilet call on a Saturday night? You can hire a property manager to deal with it, but even so, you still have to oversee your managers and take care of larger issues. If you don't think you can handle it, consider some less active ways of getting involved in real estate such as investing in crowdfunding, syndication, or a REIT.

Yes, being a landlord can be a pain sometimes, but I believe that the pros of owning real estate directly still outweigh the cons. With a good property manager, small issues will be taken care of and you should only be notified of major issues and larger expenses. Just be sure you know what you're getting into.

3. Understand How to Work the Numbers

Money, as they say, is made **at the time of purchase**. In other words, how well you buy determines how much you'll make. This is absolutely true. The "buy first, ask questions later" mentality will only get you into trouble down the road.

Do you know your net operating income? Do you know your expected ROI (return on investment)? What's your cash on cash return? Fortunately, these numbers aren't extremely complicated but are pretty simple math as I've shown in Real Estate Finance is as Simple as Calculating I's and O's.

It's important that you educate yourself on and fully understand all the different methods of making money in real estate and how to plan for different exit strategies. Not sure where to start? I recommend reading The ABCs of Real Estate Investing. After that, I highly recommend paying a visit to BiggerPockets.com.

Is it Worth Investing in Real Estate?

Ultimately, investing in anything is a risk, and real estate is no exception. However, it is my belief that the rewards can far outweigh that risk. Just ask anyone who has a portfolio of cash-flowing properties large enough to cover their expenses. Now that's passive income and financial independence.

Real estate helped jumpstart my goals of early retirement, and it can do the same for you. Making sure that you’ve considered these issues up front will help make that journey even easier.

Do your research, consider the pros and cons, and finally, start your own path to financial independence, made possible by rental income.

What else do you think needs to be considered before jumping into owning your own properties?