

Downpayment Options on Rental Properties

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Last month we talked about the obstacles you will face when looking to develop a real estate portfolio. As previously discussed, a real estate investor will be faced with two major obstacles when trying to develop their portfolio. The first is their ability to qualify at the bank based on debt service ratios. The second is their ability to come up with sufficient down payments.

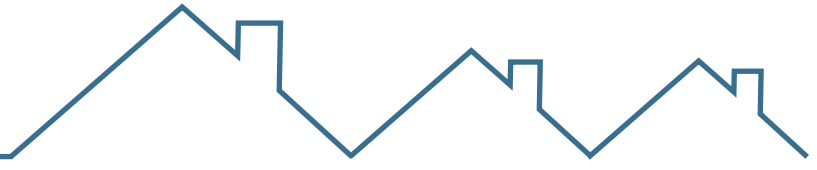
This month we will be focusing on the second obstacle.

The down payment obstacle is probably the most common issue that thwarts potential investors and unfortunately, it is an area that has the most misleading information. The most common question I get from investors is how to make a limited amount of equity stretch over a maximum number of investment properties. As you may know, the standard down payment requirement for most lenders is 25% and in some cases 35%. But what do you do if you want to buy 4 or 5 properties over the next few years and you have a fixed or limited amount of money available for the down payment? Outside of liquid assets or cash, here's a list of seven options that I know of:

1. Use equity from an existing property to access the 25% down. This is the easiest and most cost effective source of capital and will give you the best rate available in the market with no fees. The equity you access can be a secured Line of Credit (LOC) set up against your principle residence or it could be from refinancing an existing revenue property that has built up some equity. Remember too that any interest paid on a LOC that is used for investment purposes is tax deductible.
2. CMHC insured – high ratio rental mortgage up to a maximum of 85%. But a caution here – qualifying criteria is very strict and CMHC fees are higher than for owner-occupied properties. Remember, as soon as you want to have a high ratio insured mortgage, you have to be willing to play by CMHC rules – and they require a minimum of 15% down.
This may change soon, however, since we are about to have a few newcomers enter the Canadian Mortgage Insurance market. AIG and Genworth are talking about offering insured mortgages on rentals for up to 90% of the purchase price, but as of yet, no banks have come on board. So stay tuned.
3. CIBC and FirstLine Mortgages have an 'option' product that allows you to put 15% down on a rental property but the rate is closer to posted with a small fee (around \$300). This can be a good option for a client that is looking at making the down payment stretch over two properties and there is great cash flow. GMAC also offers a similar program with as little as 15% down, but again, the mortgage is not fully discounted.
4. XCEED Mortgage now offers 100% financing for revenue properties – so in essence you now have a true zero down option as an investor. The rate is a little higher than posted though (currently just over 8%) along with a small fee. This obviously isn't for everyone as the cost of borrowing is higher than conventional rates with 25% down, however there are circumstances in which this product could be either a good choice or a last resort. This option could be a valuable tool for someone with an existing portfolio looking to access some cash to grab that 'great deal'. Not a perfect solution, but good to keep in mind.
5. Wells Fargo and Accredited Home Lenders: Relative newcomers in the Canadian mortgage market, they are making inroads into the Canadian sub-prime market much like Xceed with the availability of 100% on financing owner occupied properties at higher rates. They do have some products for the rental market, but make it very clear that their main focus is on the homeowner. Both companies will finance the purchase of a rental property with only 15% down, but the interest rate will be adjusted upwards similar to Xceed. A third player in this mix is Resmor Trust. They also have a limited rental program, similar to the others I have mentioned, but the one big difference is that they will allow a second mortgage registered on title up to 100% - a feature that is not normally allowed. It is also important to note, that all three of these lenders will only do one (maybe two) rental properties per customer.

****CAUTION*****

With all of the above options, please note that obstacle #1, which was discussed in last month's Newsletter,



was all about your debt-service ratios. You may recall that we emphasized the need for those building a large portfolio to focus on a positive cash flow (especially if you're self-employed). With our current market conditions, this is getting increasingly more difficult with 25% down. If you do go for one of the sub-prime options, the lower down payment combined with the higher interest rate will make it even more difficult to get cash flow. So before you go for the 'quick-fix', be absolutely certain that you will be able to qualify for your next purchase as well if you had to go back to a conventional lender.

6. Vendor Take Backs: VTB's for up to a maximum 15% are allowed by most banks. Please note, in almost every instance, the lender will still want to see at least 10% of your own money into the deal. To my knowledge, there are no Canadian lenders that will allow the full 25% of the down payment in the form of a VTB outside of Resmor Trust. The bank will factor the cost of the VTB into your debt servicing even if it's an interest only balloon payment at the end of term. In most cases, the higher the VTB, the more scrutiny you should expect from the bank. If you're looking to put only 10% down, expect a lot of paperwork. VTB's are harder to come by these days as it requires a motivated vendor – but keep in mind, you don't know if you don't ask!

7. Joint Venture partnership. This is the most ignored option, but can be the best. You become the deal maker and then look for an investment partner who has the money to cover the down payment. A note of caution here, the JV partner will, in most cases, go on title, and as such, you will need to debt service their liabilities as well. Think of JV partners like hooking up with someone for a potluck – if you're bringing dessert it doesn't make much sense to find someone with a chocolate cake. Make sure your JV partner brings something to the table that you don't have.

I will devote a future article to this topic.

There may be more options available, but this is a good list to start with. As I sit down with clients, I like to remind them that as they look over their 5 year plan of action, they will inevitably be faced a few challenging decisions along the way over rate, product etc. The best way to decide which course of action to take is to be clear on your goals. Keeping focus on your goals makes decisions along the way a lot easier to make.

Happy Investing!

Peter Kinch
pkinch@peterkinch.com