

Using CMHC mortgage insurance can lower the interest rate on cash-flowing properties

Financing rental buys

More real estate investors are making the shift these days from buying single-family homes or condos to multi-family apartment buildings. As an investment strategy, buying a multi-family building definitely has its benefits – the most obvious of which is that you are able to create some economies of scale by having only one property to maintain and one property manager to look after it.

However, there are differences between residential and commercial mortgages. First, the costs associated with commercial mortgages are much higher – interest rate, fees, legals, inspections, environmental studies and appraisals, for instance. Yet, there is one major exception – a **Canada Mortgage and Housing Corp.** (CMHC) insured mortgage.

Typically, anyone looking to get a commercial mortgage is expecting to have to put more money down, pay a higher interest rate and a higher fee. But if you buy a good quality apartment building with CMHC insurance, the interest rate can actually be less than the best fully discounted rates available to residential buyers and often as much as two per cent lower than an uninsured mortgage on the same building.

When buying a residential property, high ratio insurance is available from one of four insurance companies, and the loan to value can be as high as 100 per cent. However, for most lenders, the fact that the loan is insured doesn't change the interest rate. With a commercial

mortgage however, CMHC is the only player in the high-ratio sandbox. With literally no competition, they can set their own rules. As such, they have compiled some intimidating fees and limiting rules to offset the perceived higher risk associated with insuring a commercial mortgage.

Loan to value ratios

To start with, there is no 'zero-down' 100 per cent financing available with commercial real estate. CMHC will only go to a maximum of 85 per cent loan to value (LTV). If any component of the property is not residential (e.g. restaurant, dry cleaner, mixed use), then the loan cannot exceed 75 per cent. In fact, the non-residential components of the building cannot comprise more than 20 per cent of the gross floor area. And, unlike residential mortgages, CMHC will charge an application fee based on the number of doors you are buying. Properties with one to four units will have an additional fee of \$600 per door. Properties with more than four units have a fee of \$150 per unit to a maximum of \$50,000. In addition to these fees, the insurance premiums can be as high as 4.5 per cent of the loan amount on a mortgage that is 85 per cent LTV. If you want to extend your amortization beyond 25 years, there is an



additional quarter point premium for every five years beyond 25 up to a maximum of 40 years (as long as the economic life of the building is at least five years longer than the amortization period). These premiums can be added to the loan amount, but are due and payable upon advancement of the mortgage.

Because of these additional costs, a lot of investors dismiss using CMHC as a source of funds. However, what a lot of people don't realize is the significant savings they can get on the interest rate. The major difference in rates stems from the fact that any lender who picks up this mortgage is effectively getting a CMHC certificate of insurance against the borrower defaulting on the loan. Even with the lenders factoring in some risk pricing, the cost of a CMHC-insured commercial mortgage is surprisingly inexpensive compared to a conventional commercial loan.

Hold or flip

The key to knowing whether or not a CMHC-insured commercial mortgage is right for you is the length of time you intend to hold it. If you are buying the property with the intention of flipping it within a year or two, then the fees and costs associated with getting it, do not make it worth while. However, if you are making the purchase as a long-term hold, then the lower interest rate will more than justify the additional costs after the third year or so.

Now you're probably thinking, "That sounds great – but what's the catch?" Well the catch is that you have to qualify for the CMHC loan. Or to be more precise – your property has to qualify – and therein could be the problem. One of the key areas that CMHC looks at is cash flow of the building, and this is the area that poses the single biggest challenge today.

Cash flow strategy

CMHC is fairly strict in its cash flow analysis of a building. They like to see a debt coverage ratio (DCR) of 1.1 for a building with one to six units, between 1.2 and 1.3 for more than six units and up to 1.6 for non-residential units.

(Note: DCR is the ratio of income to debt; e.g., a 1.2 DCR means that there is a \$1.20 of income for every \$1 of debt. In other words – positive cash flow.)

Anyone who has tried to buy a multi-family building in Vancouver, Calgary or Edmonton recently will tell you that it is hard enough getting positive cash flow with 25 per cent down, let alone 15 per cent. So don't be surprised if your application for a CMHC-insured loan comes back at 65 per cent LTV or less. If this does happen, there is a way of dealing with it as long as you know that the rents are going up in your building (as is the case in many Alberta apartments these days).

Take the CMHC insured first mortgage at the discounted interest rate and low loan to value and back it up with a more expensive second mortgage at closing time. The interest rate and fee may be pricey for the private second, but if the rents go up enough to make the numbers work with CMHC – simply refinance out of the private mortgage once the cash flow matches CMHC's DCR requirement.

The only caution to this is that you must know what you are doing. If you have misread the market and your rents don't go up, you have to be in the position to carry that expensive second mortgage longer – so it is definitely not something to gamble with. Do your homework carefully.

Buying multi-family commercial buildings can seem fairly intimidating and costly at first, but once you understand the 'rules of engagement' and are comfortable with the inherent risks, you'll find it can be much more rewarding than buying single-family homes. Just ask anyone who has bought a few.

If you do make the shift to the commercial side of the investment pool, at least you'll now have a better understanding of some of the rules of engagement. ♦

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