

Lenders take different approach, often based on the number of units that are being purchased

Multi-family financing

I recently received a call from a client who had just put an offer in on a property and needed a mortgage. They had purchased a four-plex only a few months earlier and wanted to know if they could get the same discounted mortgage rate for this purchase.

Normally I'd say, no problem, but upon further examination of their deal, I discovered that the property they were buying was an eight-plex. What's the big deal you might ask? Well, the problem is that the purchase of the four-plex fell under the definition of 'residential' financing, whereas an eight-plex is considered a 'commercial mortgage,' and the difference between financing the two is quite significant.

This simple misunderstanding is probably one of the most common misconceptions in mortgage financing. Many investors do not realize that there is a major difference between residential financing and, as such, enter into purchase agreements with false expectations and often end up disappointed and frustrated.

The fact is individual lenders have different guidelines governing commercial and residential real estate financing.

Defining the term

First off, let's define when a mortgage is deemed to be commercial or residential. A single unit, duplex or triplex will always be considered a residential property for mortgage purposes. Virtually every bank will treat a four-

plex as a residential mortgage as well. However, this is the cut-off point for some lenders, and they may only choose to do a four-plex as a residential mortgage on an exception basis (for example, the application must be strong). A five-plex is completely in the 'grey-zone' – most residential lenders opt out at this point, and your broker will have to do some digging to find a lender who will treat this as residential.

A six-plex is where 99 per cent of the residential lenders will opt out. There is one lender in Canada who is currently treating up to eight units in a multi-family complex as residential, but they are only doing so in Ontario at this point. The other obvious clue that makes property residential versus commercial is the zoning. Quite often this comes to light when the broker or banker receives the appraisal.

(Note: Don't confuse an eight-plex, which has eight separate suites, each having its own entrance and each being fully self-contained, with a residential house that has eight rooms rented out and a hot-plate in each room for cooking. The latter is considered a 'rooming-house,' and the banks will scatter quickly if they read this in an appraisal. So if you're buying one, expect even more problems. The same is true for 'student housing.')

Underwriting changes

So what difference does it make if a property is considered commercial or residential?

First of all, the entire underwriting process changes. The simple explanation is that with residential, the borrower is the main focus and the property is secondary. With commercial, the property becomes the focal point and borrower become secondary – which may come as welcome news for some.

The biggest difference between the two is the cost of doing business. In residential, the interest rate is very predictable, there is no lender fee, the appraisal costs are low and the legal fees are standard. All of these change, however, when you buy a multi-family/commercial property. The rates could be higher; the bank charges a fee – as does your broker.

The appraisal costs start at \$1,200 and can go much higher. The legal and accounting fees will be higher. Your residential home inspector is not the same person you will use for a commercial property inspection, and, lastly, the lender will likely

ask for a Phase 1 Environmental report on the property.

Three variables

Remember, although the potential costs are higher with commercial property, so too are the potential rewards.

Let's look at the three main variables that can be negotiable from deal-to-deal on a commercial mortgage: the loan-to-value ratio, the mortgage interest rate, and the fees.

These three items will be determined on a case-by-case basis after the lender looks at the following four items:

1. The age and quality of the building;
2. The vacancy ratio of the building and the surrounding area;
3. The cash flow from the property (debt coverage ratios); and
4. The strength of the borrower (both from a financial/net worth perspective and management perspective).

Downpayment

So let's take a closer look at how much each of these three items can change as compared to a residential investment

The loan-to-value ratio:

- On commercial purchases, this can vary from 50 per cent to 85 per cent of the purchase price. In other words, a lender can ask that you to put as much as 50 per cent down on your purchase.

- In order to get away with as little as a 15 per cent down payment, the deal would need to be insured by Canada Mortgage and Housing Corporation (CMHC).

If one of the four aforementioned factors is weak, then the bank may require a higher down payment.

Don't expect to be able to buy a 12-plex with five per cent down

The mortgage rate:

- Typically rates will range from one per cent to three per cent higher than residential rates.

- If your deal is insured by CMHC, the rates could be significantly lower.

The fee:

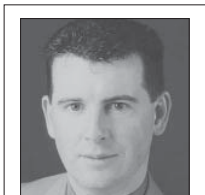
This is the biggest difference between commercial and residential mortgages and an area that catches most novice commercial borrowers off guard.

Whereas the lender in the residential sector will pay the mortgage broker a fee for bringing them new business, the commercial lender not only does not pay a fee – they charge one. And, since the lender will not pay the mortgage broker, the broker will charge the borrower a fee.

The combined broker/lender fee can range anywhere from one per cent to five per cent of the mortgage amount, depending on the deal.

In summary, multi-family real estate can be an exciting and profitable venture for an investor, but having a better understanding of the rules to play by can minimize your stress and frustration. ♦

Peter Kinch is the owner and senior mortgage broker with Port Moody B.C.-based Mortgage Centre – Canadian Mortgage Team. He is a co-author of 97 Tips for Canadian Real Estate Investors. Contact Kinch by phone at 604-939-8326 or via www.peterkinch.com.



**REAL ESTATE
FINANCING**

PETER KINCH