Buying Your First Rental Property

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OWN YOUR PRIMARY RESIDENCE

Generally speaking, it is recommended that you own your primary residence first before buying your rental property.

This is primarily due to the lower barrier of entry into the housing market since you could put down as little as 5% when buying a home you will live in. On the other hand, the minimum required down payment for a rental property is usually 20-25% and the mortgage interest rate is also typically a little higher.

There are exceptions to this recommendation, however, when buying a rental property first may make sense such as cultural norms of living at home with parents for an extended time, you are already living with a partner who owns a home, or it just makes more sense to continue renting your primary residence due to proximity to work, better overall cash flow due to your low rent payments for the time being etc). As with any and all forms of investing though, it is best to get started early with real estate so you can put time on your side. The common adage is “buy real estate and wait, not wait to buy real estate.”

WHY INVEST IN RENTAL PROPERTIES?

Ok so you have figured out your primary living arrangement. The next question then is why invest in a rental property?

Billionaire Andrew Carnegie famously said that 90% of millionaires got their wealth by investing in real estate. There is no hard data to verify this, but it is fair to say that real estate holdings account for a significant portion of net worth amongst the most wealthy in the world.

• DIVERSIFICATION. Many investors own traditional investments of stocks and bonds in their portfolios. Adding real estate investments diversifies your portfolio with non-correlated assets. The recommendation is based on the wealth-producing traits of real property: appreciation (over the long term), equity, and, potentially recurring rental income.

• TANGIBLE ASSET. Rental properties are physical investments that have a functional use in the economy. Even if the value of the home drops due to market conditions, someone can still live in the house and generate rental income.

• THE POWER OF LEVERAGE allows you to control a large asset with a smaller investment. When you purchase a property, you can put down the minimum down payment and finance the rest. Down payment can be as little as 5% down for your primary residence and 20% down for investment properties.

• ATTRACTIVE RETURN ON INVESTMENT (ROI) due to the power of leverage. Here's an example of leverage in action:

PURCHASE A RENTAL PROPERTY WITH 20% DOWN	PURCHASE A RENTAL PROPERTY WITH 5% DOWN
PURCHASE PRICE 500K	**PURCHASE PRICE 500K**
• Put down 20% (100K)	• Put down 5% (25K)
• Property appreciates by 3% (15K)	• Property appreciates by 3% (15K)
• Return on your Investment: 15%	• Return on your Investment: 60%
• Power of leverage: Every 1% in appreciation, you earn 5% on your money invested!	• Power of leverage: Every 1% appreciation, you earn 20% on your money invested!

Note: annual appreciation is not going to be a straight steady increase of 3%. There will be periods of declining prices, flat prices, and rapidly rising prices and it may take 5-15 years before that average annual rate of appreciation is realized.

Three Pillars Of Return On A Rental Property

1. Monthly cash flow
2. Mortgage principal pay-down
3. Market value appreciation

MONTHLY CASH FLOW

Cash flow = Gross rental income minus total operating expenses (mortgage payment, strata fee, property tax, maintenance).

Depending on location and the market, cash flow could be positive, neutral, or even negative. Therefore, it is critical for you to do the math to ensure what the cash flow looks like on a prospective property.

Your foray into investment properties may not be sustainable long enough to realize any appreciation in the value of the property if you have to inject money to cover shortfalls in cash flow each month over an extended period of time. Ideally, after expenses, what you have is monthly, recurring passive positive (or even neutral) cash flow. In general, depending on location and type of property, a cash flowing property in Canada provides about a 1-4% return on cash per annum.

It is not usually the primary component of return on investment, but a critical one as it determines whether an investment is sustainable or not over the course of 1, 2, 5, 10 years.

MORTGAGE PRINCIPAL PAY-DOWN

Of all the three pillars of return, mortgage principal pay down usually does not jump to mind first, like cash flow and price appreciation. As you make your monthly mortgage payments, each payment is a blend of interest paid to the lender and reduction in your overall mortgage principal balance owing.

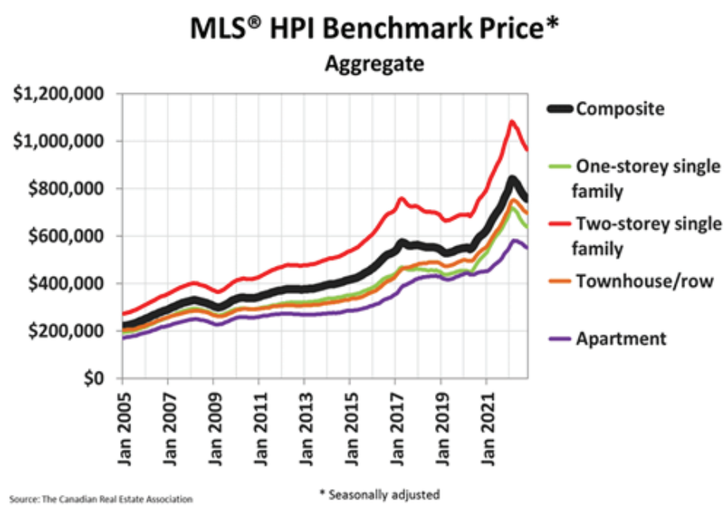
Even if a property is neutral cash flow, principal pay down by your tenant allows you to build your equity position, month by month, to owning the property free and clear. If the property is positive cash flowing, your tenants are helping you build your wealth and equity at the same time!

In a scenario where you buy a property for 500K with a 20% down payment (100K) and finance 400K, your tenant will have helped you pay down the principal (increase your equity position) by approx. 43K over a typical 5 year term. That is an average of 8.6% ROI per annum on your money invested from principal pay down.

Principal reduction on an initial 400K mortgage loan at 5.54% interest rate and 25 years amortization:					
After Payment #	Opening balance	Principal (P)	Interest (I)	Total P&I	Closing balance
12 (1 yr)	$392,976.18	$682.78	$1,768.11	$2,450.89	$392,293.40
24 (2 yrs)	$384,934.26	$718.96	$1,731.93	$2,450.89	$384,215.30
36 (3 yrs)	$376,380.06	$757.45	$1,693.44	$2,450.89	$375,622.61
48 (4 yrs)	$367,345.67	$798.10	$1,652.79	$2,450.89	$366,547.57
60 (5 yrs)	$357,804.13	$841.03	$1,609.86	$2,450.89	$356,963.10

PROPERTY APPRECIATION

If the property you own increases in value over time, you can sell it for a solid profit. Remember, though, appreciation is not guaranteed. You will need to invest in the right property and for the most part have a buy and hold strategy, perhaps over several years, in order to see those big returns through price appreciation. See the chart to the right of the average home price in Canada since 2005. If held for the long-term, real estate is an asset class with tremendous appreciation growth. Growth will not follow a linear path, but over a window of 5, 10, 15, 20 years, it is apparent that the trend line is positive.



Buying Under a Holding Company, Operating Company, or Personal Name

FOR TAX EFFICIENCY AND RISK MITIGATION, INVESTORS WHO INTEND TO ACCUMULATE A LARGE PORTFOLIO OF RENTAL PROPERTIES WILL OFTEN CONSIDER SETTING UP AND REGISTERING OWNERSHIP OF ALL PROPERTIES UNDER A HOLDING COMPANY.

The main difference between a holding company and an operating company is that a holding company is not active. It only holds investments such as company shares, interest earning investments, or real estate. All of its revenues can only be derived from the assets that it holds, such as rents from real estate.

An operating company on the other hand is active in selling goods and services. It is highly recommended that you consult a lawyer to set up the holding company as well as an accountant to provide guidance on how to structure share ownership in the most tax efficient way.

As mentioned, most investors will consider setting up a holding company when the plan is to scale and eventually own a large portfolio of rental properties. There really is no exact number of properties to trigger this move, but generally speaking it would make sense to do so when tax efficiency and risk mitigation becomes a high priority despite the cost of setting and maintaining a holding company.

In terms of tax efficiency, this usually revolves around tactics such as having the holding company borrow down payment funds from the operating company. Having properties owned under a holding company also limits exposure of an operating company's assets in the event the operating company is the subject of a lawsuit. Advantages aside, not all residential mortgage lenders offer financing under holding company name (and even fewer under operating company). Hence, this usually requires buyers to also explore financing through small business or commercial banking (which also have a different set of advantages and challenges).

Finally, the interest rate and fees associated with financing under a corporate entity are usually higher compared to financing under personal name.

Access To Capital For Down Payment

THERE ARE A VARIETY OF SOURCES FOR THE REQUIRED DOWN PAYMENT ON AN INVESTMENT PROPERTY.

We will only discuss the two most common sources for investors purchasing their first few rental properties. Please note that one well known source of capital for investors of rental properties is a Joint Venture (JV) where a number of investors pool their money for the required down payment or have an agreed upon partnership where there are clear roles of being a provider of the down payment, qualifier for the mortgage, and person who will maintain and operate the rental properties. For our purpose here, we will focus on non JV sources of capital for down payment being a Home Equity Line of Credit (HELOC) and personal savings/investments.

HOME EQUITY LINE OF CREDIT (HELOC)

Savvy investors understand the power of leverage so the first source of down payment would

usually be the equity in their primary residence via a readvanceable Home Equity Line of Credit (HELOC). Most big banks and credit unions, as well as several non-bank lenders in Canada offer readvanceable HELOCs that are registered against a primary residence (and in some cases even rental properties). Think of HELOCs as a giant line of credit that allow you to access credit of up to 65% of the market value of a property. It could be set up in conjunction with a traditional term mortgage when you first purchase your primary residence so that as you pay down the principal on the term mortgage, the limit on the HELOC increases proportionately, allowing you easy access to equity that you could then use to form the down payment for a rental property.

> "Most investors would consider setting up a Holding Company when the plan is to scale and eventually own a large portfolio of rental properties.

Alternatively, a HELOC could also be set up by refinancing at a later time once you have built up sufficient equity (usually at least 35% equity position). The minimum payment each month is interest-only on the outstanding balance.

Unlike a traditional closed mortgage, you could also pay off the entire balance of a HELOC at any time without being charged a prepayment penalty. Take note though that not all HELOCs are created equally as it could also be set up entirely separate from your term mortgage (as a 2nd charge against title). If it is set up separately as a 2nd charge, the credit limit will not increase as you pay down the principal on your term mortgage. It is advisable that you set up a readvanceable HELOC such as a TD Flexline, Scotia STEP, RBC Homeline Plan, CIBC Home Power Plan, BMO Homeowner Readiline, Manulife Bank's Manulife One, etc.

SAVINGS & LIQUID INVESTMENTS

Using your savings and liquid investments for a down payment on a rental property is certainly an option, however, investors would usually look at the opportunity cost of doing this – would they be able to achieve a higher Return on Investment (ROI) if those savings and investments were deployed in different asset categories? For investors, using savings and/or cashing out investments for a down payment would reduce their rate of return due to less leverage. However, this is not so say that using your savings or cashing out investments to fund your down payment is not recommended since it could help ensure a positive or at least neutral cash flow which is critical to allow you to hold onto the property for a longer period of time (to realize price appreciation).

Qualifying For A Mortgage For Your Rental

Lenders approve financing based on a thorough assessment of what is referred to as the 5 C's of credit.

THE 5 C'S INCLUDE:

- CREDIT (Satisfactory credit score)
- COLLATERAL (quality of the property offered as security for the loan)
- CHARACTER (past repayment history and behaviour)
- CAPITAL (your personal assets as well as level of down payment), and finally
- CAPACITY (ability to carry payments and repay the loan).

Of the 5 C's, the Capacity to carry payment and repay the loan is critically analyzed by lenders. Most lenders do this by not only verifying your personal income from employment, but they will also allow use of rental income from the rental properties. Rental property income is factored into the equation differently across lenders however.

See examples below of the three common ways rental income is used by different lenders:

50% ADD TO INCOME

Let's suppose your monthly mortgage payment is $1000 and your rental income is also $1000/month. This would result in a neutral cash flow for the investor each month (not accounting for condo fee and property tax as some lenders do and to keep it simple here). However, for qualifying purposes, some lenders will only use 50% of the rental income and simply add that amount to your total verified employment income for debt servicing.

- $1000/month rental income x 50% = $500
- $500/month x 12 = $6000 extra annual income for qualifying
- $6000/year extra income will help qualify for approx. $24,500 more mortgage money as of the writing of this guide.

50%-90% RENTAL OFFSET

On the other hand, there are lenders that will allow a more aggressive application of rental income by using between 50-90% of the actual rental income to directly offset the monthly mortgage payment which will have a much more positive impact. Using the same example of rental income of $1000/month, but a 90% rental offset, $900 will be used to first reduce the mortgage payment directly.

- $1000/month rental income x 90% = $900
- $1000/month mortgage payment minus $900 rental income = only remaining $100 / month that your income must be able to debt service
- $900/month reduction in expense = approx. $125,000 in mortgage money as of the writing of this guide.

DEBT SERVICE COVERAGE RATIO (DSCR) APPROACH

With this approach, lenders would require all rental income and operating expenses related to an entire portfolio of rental properties to be input into a spreadsheet. Each property's revenue-to-expense ratio will be assessed by a metric called Debt-Service-Coverage Ratio. Ideally, each property's gross rental income should cover all of the following typical expenses at a ratio of 1.20 or higher:

- Mortgage Principal + Interest and HELOC interest payments
- Typical vacancy of 5% of the rental income
- Insurance
- Maintenance
- Condo fee
- Property tax

In fact, lenders typically want to see that an entire portfolio of rental properties collectively achieve the 1.20 Debt-Service Coverage ratio. If, however there is a deficit each month, then that amount would be added to monthly liabilities and the borrower's income must be able to support the shortfall each month as well as all other loans, credit cards, etc. As you acquire more properties, it may be increasingly difficult to qualify since your income may have to support a growing shortfall each time an additional property is added to the picture.

Not all lenders treat the overall shortfall the same way however. A few lenders allow the total shortfall to be subtracted from the annual employment income. This reduces borrowing power less than if the shortfall were treated as a monthly recurring liability. This is technical underwriting mathematics, but the point is, there are variations in how lenders use rental income when qualifying a borrower.

	Rental 1	Rental 2	Rental 3
Street address	133 Smith Street	500 - 1000 Howe Street	450 - Ascot Street
City	Vancouver	Vancouver	Vancouver
Province	BC	BC	BC
Postal code	V6A 1K3	V5A 2Z7	V3K 1H1
Date purchased	Mar-10	Sep-17	Jun-19
Original price	575000	600000	700000
Estimated current market value	$1,000,000.00	$900,000.00	950000
1st Mortgage balance owing	$200,000.00	$350,000.00	400000
1st mortgage monthly payment	$1,200.00	$1,800.00	2000
2nd mortgage balance owing / HELOC balance	$0.00	$0.00	0
Monthly 2nd mortgage payment	$0.00	$0.00	0
Lender/Bank	TD	Scotia	RBC
Gross monthly rental income	$3,000.00	$3,200.00	2400
Total gross income (annual)	$36,000.00	$38,400.00	$28,800.00
Annual 5% vancancy	$1,800.00	$1,920.00	$1,440.00
Annual Maintenance / repair	$1,000.00	$1,000.00	750
Monthly Condo fees (if applicable)	$400.00	$275.00	350
Annual home insurance	$750.00	$750.00	600
Annual property tax	$1,200.00	$1,000.00	800
Total Annual Operating expense	$23,950	$29,570	$31,790
DSC ratio	1.50	1.30	0.91
Total DSC ratio	1.21		

Quick Rules Of Thumb To Analyze A Deal

CALCULATE THE PRICE-TO-RENT RATIO

People deciding between renting or buying often use the Price-to-Rent ratio to determine whether it makes more financial sense to rent or own. The Price-to-Rent ratio is calculated by taking the median price and dividing it by the median annual rent in a specific area. For example, if the median price for a condo in a particular area is 500K and the median rent is $2000/month, the Price-to-Rent ratio would be 20.8. What does this number mean?

- Price-to-rent ratio of less than 15: It is cheaper and more affordable to buy versus rent.
- Price-to-rent ratio of 16-20: Lean towards renting as a better option over buying.
- Price-to-rent ratio of over 21: renting would make more financial sense

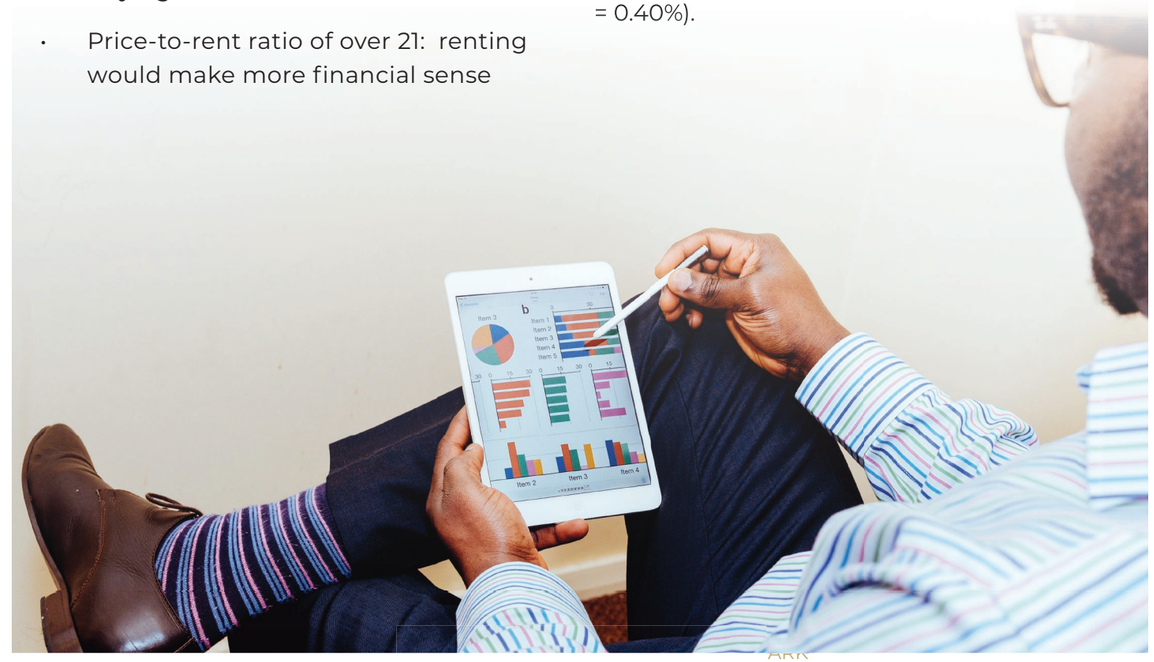
HOW DO YOU USE THIS METRIC AS A REAL ESTATE INVESTOR?

You can also use the Price-to-Rent ratio to identify the areas that could be good for owning rental property. By investing in areas where the demand for renting is strong, investors may earn higher returns than in markets where people could afford and prefer to buy rather than rent.

CALCULATE THE RENT-TO-PRICE RATIO

The Rent-to-Price ratio can be calculated by dividing a property's monthly gross rent by its purchase price. Typically, a ratio of 0.40% would be ideal.

For example, if you are considering a 500K property then you would ideally want a monthly rent of $2000/month ($2000/$500,000 = 0.40%).



Real estate investors often use the Rent-to-Price ratio when evaluating and comparing potential rental properties.

Let's assume you are interested in buying condo A for $750,000 and it could be rented out for $3500/month. The Rent-to-Price ratio would be 0.46%.

Alternatively, there is condo B priced at $325,000 and commands $2000/month in rent. The Rent-to-Price ratio would thus be 0.61%.

While condo A's higher monthly rent may seem more attractive, it is actually more expensive to purchase, as indicated by its lower Rent-to-Price ratio. Even though the potential gross rents may be higher, you will be paying more in purchase price for every dollar you get back in rent.

Condo B would be a slightly more attractive investment from a valuation perspective as indicated by a higher Rent-to-Price ratio (all other things considered equal).

MONTHLY PAYMENT PER 100K OF MORTGAGE

Calculating the monthly mortgage payment per 100K will allow you to quickly assess the cash flow of a property. As of the writing of this report (Dec 2022), the monthly payment per $100K of mortgage principal borrowed is approx. $575/month. If you purchase a condo for 500K with 20% down (100K), you will be carrying a 400K mortgage. This will translate roughly to a monthly mortgage payment of approx. $2300/month. Factoring in strata fees and property tax, you will need to charge rent in the $2700-2800 / month range to achieve a neutral cash flow or better. If market rent is well below this then you will have to consider putting down a larger down payment to achieve a cash flowing property or look in a different market altogether.

After all, you want to be able to hold onto a property long enough to realize the appreciation in market value. If you have to cover a shortfall every month, you may have to inevitably sell prematurely.

Investing In Presale Condos

Purchasing a presale condo is different from purchasing an existing property because of three things:

1. A longer completion date - well beyond the regular mortgage approval window of 4 months. Most presales complete anywhere from 1 year to 5 years out.
2. Requirement to pay deposits of up to 20% to the developer within 6-9 months of signing the presale purchase agreement
3. GST is applicable and usually not included in the price on the purchase agreement

LONGER COMPLETION DATE

Most of the big banks such as TD, RBC, BMO offer special mortgage approvals specifically for presales with expected completion dates beyond the regular 4 month approval period (for the resale market).

These banks would work directly with the developers to get all information about the projects including unit prices, floor plans, and incentives with the intention of streamlining the approval process and offering mortgage approvals that are valid for up to 2 years, without having to revisit income and credit rating.

Each bank will often perform a blanket appraisal of all units in the project upfront (using market data and price lists provided by the developer) which is then used to underwrite and approve mortgages for buyers of the presale units. The mortgage interest rates promised for presales are usually anywhere from 1% - 2.5% higher though to account for risks associated with the longer completion timeline.

Buyers are never legally bound to complete their purchase with the presale mortgages offered to them by the bank – in fact for the buyers, it is often arranged as more of an insurance policy to have in their back pocket to hedge against rising interest rates while they wait for completion as well as to guard against any changes in their income and credit rating.

The presale mortgage approvals are usually final approvals and not subject to review again for up to two years if there is no material change to the mortgage application (loan amount, applicants, and assuming they have met all conditions for final approval). This is very beneficial for buyers who have unexpected changes in their employment and / or credit rating while waiting for completion.

PAYING REQUIRED DEPOSITS TO DEVELOPER

Most developers require buyers of presales to pay 2-4 deposits totaling up to 10-20% of the contract purchase price over a period of months (typically 6-9 months) following the signing of the purchase agreement.

These deposits will go towards the buyers' down payment and be held in-trust by the developer's lawyer until completion. Buyers must pay the required deposits to the developers from their own resources first.

In some cases, buyers may not have the required deposit amounts since they plan to save more money for down payment while they wait for completion or their intended down payment is less than the total deposits required upfront by the developer. For example, if a buyer is currently still saving for their intended 10% down payment, but the developer requires 20% in deposits be paid upfront. In this scenario, the buyer would likely have to seek a temporary deposit loan from their own bank or from a deposit loan company.

The practice of collecting deposits in this manner is mostly to ensure that the developers themselves could meet conditions for construction financing with their commercial bank(s). Developers must demonstrate to their commercial banks that a certain percentage of presale units have been sold along with a minimum amount of capital has been secured to start construction.

GST ON PRESALES

The contract purchase price for presales is usually exclusive of GST. The buyer could choose to pay for the GST separately on closing through their lawyer. Alternatively, they could also ask their mortgage lender to roll the GST into the purchase price for financing purposes.

For example, if the contract purchase price is 500K exclusive of GST, lenders could roll the GST into the price by using a price of 525K. The borrower could then put down 20% (105K) and finance the remaining 420K. In this manner, the borrower does not need to come up with the entire 25K for GST on closing out of pocket.

Investing in Flips

A flip is a real estate investment strategy whereby you purchase a property,not as a long term hold but rather to quickly re-sell at a higher price.

The higher price could be realized if the market is a hot market and prices are rising quickly or through 'forced appreciation' by buying a property that is cosmetically tired and quickly renovating it to increase the value of the property before re-selling it for a profit.

An example of the latter is if you purchase a property below market value for say 600K.You then immediately spend 40K on cosmetic upgrades such as upgrading the kitchen and bathrooms, painting the interior, putting down new laminate floors, and updating fixtures throughout.

The renovation immediately raises the value of the property by 100K, making it comparable to other 700K properties on the market. You manage to sell it quickly for 700K cashing in a quick profit of 60K (before selling expenses). In a nutshell this is what a flip is.

Generally speaking, using the Home Equity Line of Credit against your primary residence to finance the purchase and cost of renovations involved in a flip is the best option if you have sufficient equity to do so.

I would not recommend taking out a conventional closed mortgage against the new property that you intend to flip since flips are quick transactions and you do not want to be assessed a penalty for breaking a closed mortgage prematurely.

The shortest term mortgage is 6 months which is still long for flips in most cases. Paying a penalty to break a term mortgage early would only cut into your potential profit unnecessarily.

For the most part, you will have to fund the renovations yourself and banks will only finance your purchase of the property based on the "as-is" current value of the property.

For example, if you purchased the property for 600K in our example, the maximum loan that could be granted would be $480K (80% of 600K). There are programs where buyers could purchase a property and also finance some of the renovations (improvements) as well, but

> "Focus on Cash Flow

those programs tend to be rigid with a cap on the cost of the renovations (usually 10% up to a max of 40K) and you must still have your own funds to complete the renovations upfront, only to receive a reimbursement from the bank when renovations are confirmed completed through a final inspection.

In a large percentage of flips, the borrower may even look for private financing at a higher interest rate and pay lender fees due to challenges with qualifying with a big bank or the costly

penalties that come with breaking a closed mortgage from a big bank early.

Private lenders will almost always require a property flipper to put down a sizeable down payment (usually equal to or greater than 35%). They also usually do not need to verify a borrower's income for debt servicing, but rather they are more concerned about their collateral (the property), the loan-to-value percentage, how you will be able to make payments despite non verifiable income, and very importantly - your exit strategy, since the private mortgages are usually only for a short 1 or 2 year term.

BRRRR (Buy, Renovate, Rent, Refinance, Repeat)

The BRRRR acronym stands for "Buy, Rehab, Rent, Refinance, Repeat".

This strategy involves buying undervalued properties, usually ones that are distressed or physically outdated (much like a potential flip). The difference however is the owner would refinance the property after all renovations have been completed to pull out the newly gained equity based on the new market value.

Let's go back to our previous example where you buy a property for a bargain price of 600K, with a down payment of 120k (20%) and a 480K mortgage. Let's say you then complete a more substantial 80K renovation to bring the market value of the home up to 800K. You would then refinance the property up to 80% (560K) of the new 800K value, allowing you to extract 160K in equity out to recoup all of your initial 120K down payment and half of the cost of renovations.

Initial purchase price: $600,000
Down payment: -$120,000
Mortgage: $480,000
Market value after 80K renovations: $800,000
Refinance up to 80% based on new market value: $640,000 ($800,000 x 80%)
Equity extracted: $160,000 (which allows you to recoup the original 120K down payment and half of the renovations cost). You now have an 800K asset where you only invested net 40K of capital.

As you can see, the key to the BRRRR method is buying undervalued properties, renovating them, and then cashing out equity to buy more properties.

The rent collected from tenants is used to pay your mortgage payments, with it ideally being in a cash flow positive situation.

Having said this, BRRRR properties are not bank machines that allow investors to refinance and pull cash out of their investment property indefinitely, and it certainly comes with risks. There are a number of reasons why the BRRRR method is not ideal for everyone.

HERE ARE FIVE COMMON RISKS OF THE BRRRR METHOD:

1. It can be difficult to find the right property (under-valued properties that may require extensive renovations)
2. It can lead to over-leveraging (change in market value and/or a low appraised value post renovations could mean difficulties to pull out the equity you had anticipated)
3. It can tie up your cash (many lenders will only approve the refinance of a property after a period of time, usually 6 months to 1 year after the purchase).
4. It can be time-consuming (tenants cannot move in until renovations are completed and renovations could also be delayed)
5. You need to have a good understanding of the market (as with all investment strategies, you must know the state of the market and where it is trending to compute realistic ROIs)

The BRRRR strategy could produce passive income and allow you to build your real estate portfolio over time. However, it takes patience to rehab the home, find tenants, passage of time before you can cash-out via a refinance. It is important to consider these pros and cons before undertaking a BRRRR. A traditional buy, rent, and hold investment strategy may be a better option for most people.

BUILD YOUR TEAM OF PROFESSIONALS EARLY

It is important that you have a goal and plan in place from early on. Is your plan to own 1 or 2 rental properties, or do you intend to own 5, 10 or more properties?

This will dictate everything from how to set up ownership structure (ie. holding company) to your estate planning. Regardless of your plan however, it is recommended that you form your team of professionals including a lawyer, accountant, mortgage broker, insurance broker, and of course, a realtor.

It goes without saying that you would want professionals who are experienced and trusted. Having your team of these professionals in

place early and having them communicate with each other is also highly recommended. For example, accountants usually strive to minimize taxes for their clients (which involves writing off a lot of expenses or delaying dividends to reduce income).

This could make qualifying for a mortgage more difficult, so having your accountant and mortgage broker communicating with each other to determine an income level that balances these two different objectives is very important and could prove to be the difference in having to pay higher interest rates and lender fees - or not.

IMPORTANCE OF HOME INSURANCE

Before advancing any mortgage funds to your lawyer on closing day, all lenders will require your lawyer to provide confirmation that proper home insurance has been arranged and valid.

For condos, the strata will have their master strata insurance policy in place to cover damages due to fire, earthquake, water damage, etc that affects the entire building.

As an owner of a rental strata lot in the building, you must also make sure to purchase your own condo owner's insurance which usually covers everything within your unit – personal contents as well as the physical finishings within such as floor, walls, appliances, cabinets, etc.

In addition to covering the contents within your condo unit, the condo owners insurance policy should also carry sufficient coverage to pay the required deductibles that your strata is required to pay in the event they need to make a claim through their master insurance policy to repair damages that you or your tenant caused.

It is also recommended that your tenant have their own "Tenant or Renter Insurance" to insure their own personal valuables since you may decide to only have the minimum content coverage seeing that you do not live there.

If you are purchasing an older single detached property or multi-unit residential property (ie. duplex to fourplex), always check if the electrical system is up to date (or code). Older properties could still have old knob and tube wiring that is pretty much obsolete.

Not only will this potentially pose some challenges to get proper home insurance in place, but mortgage lenders may also shy away from lending against the property until the electrical has been updated. Make sure to speak to an insurance broker about the ability to secure the necessary home insurance in advance of firming up your purchase.

A quick way to find an insurance carrier that may insure the property "as is" would be to ask the selling agent who the current home insurance provider is and doing your due diligence with that company first.

DOCUMENTS TO PREPARE FOR YOUR MORTGAGE BROKER

1. Personal Net Worth Statement listing all assets and liabilities
2. Documents to confirm all sources of income: last 2-3 years of personal income tax returns (T1 General) and Notice of Assessments (NOA) from Canada Revenue Agency
3. Bank statements confirming availability of funds for down payment: official bank statements showing all transactions from 3 months prior to mortgage application
4. Property Tax statements for all properties owned
5. Mortgage statements for all properties owned
6. Confirmation of strata fees for all existing strata properties owned (strata AGMs)
7. Holding company incorporation documents (Notice of Articles & Shareholder registry)
8. Holding company financial statements (Balance sheets & Income Statements)

3 Tips For Success

FOCUS ON CASH FLOW

Focus on your ability to carry all the monthly payments, which means focus on achieving cash flowing properties. Everyone wants high appreciation properties, but if your rental property requires you to inject money out of your own pocket each month (a negative cash flow) then you will unlikely be able to sustain this over the long term to realize the appreciation in the value of the property even for a couple of years.

ELIMINATE HIGH INTEREST DEBT AND/OR HIGH PAYMENT DEBTS FIRST

Pay off all high interest loans such as credit cards and loans with high monthly payments such as car leases and loans. Better yet, do not even take out a car lease or loan until after closing on your real estate purchase. Some finance companies may promote "zero interest for the first 1 year" or similar sales tactics, but these liabilities could cause a lot of challenges when qualifying for a mortgage.

For example, lenders will use a 3% minimum monthly payment for credit cards so carrying a $5,000 balance on your credit card will force lenders to factor in $150/month debt repayment obligation. If you also have a car lease with a monthly payment of $750/month then the total monthly debt payment obligation of $900/month will effectively reduce your borrowing power by approx. $125,000 at the current interest rate and qualifying criteria (Dec. 2022). Using the Home Equity Line of Credit

against your primary residence to consolidate all high interest debts or debts with high monthly payments would be a logical first step if you do not have other means of paying them off.

ALWAYS TAKE A 30 YEAR AMORTIZATION

Taking the longest amortization possible will give you the lowest monthly payment possible. This is preferred for rental properties to give yourself the best chance possible for achieving a neutral or positive cash flowing property. Yes, you will incur more interest over the term of the mortgage if you stretch out the amortization, but the interest incurred on rental properties is usually tax deductible. Most lenders also allow lump-sum payments of between 10-20% of the original mortgage principal each year (calendar year or mortgage anniversary). You could also increase your regular monthly mortgage payment by a similar percentage (10-20%) to aggressively pay down the outstanding principal if you wish. Make the allowable lump-sum payments and / or increase your regular monthly payment if you are able to. However, the recommendation is to always set up the mortgage with a 30 year amortization to start in order to give yourself that flexibility of a low baseline mortgage payment each month if you need it. This is even recommended for your primary residence since it could be converted to a rental property down the road in which case you could ask the lender to reduce your monthly payment back to the base line payment to help achieve a better cash flow.

The Challenges of Investing In Real Estate

While investing in real estate brings the potential for a large payday, it also comes with challenges and risks. Each investor should first weigh the following facts:

DO YOU REALLY WANT TO BE A LANDLORD?

Finding suitable tenants, dealing with bad tenants, and maintaining a property physically may not be things you want to manage personally.

You must consider if you really want to be a landlord or how hands-on you really want to be. If you prefer to be less hands-on then you could always pass these responsibilities to a professional property management company for a monthly fee - usually a percentage of rent.

LIQUIDITY

Once you invest your money in property, you will wait for some time before you could refinance to pull out any equity. Or even if you decide to sell it, it will take some time to do so. Other investments such as stocks and bonds are more liquid in comparison as they could be sold quickly.

STARTING CAPITAL

You will also need more money to get started in real estate investing (5% of 500K is still 25K). You will likely need to apply for a mortgage loan to purchase these properties. Whereas

investing in mutual funds and stocks typically require far less starting capital.

TIME HORIZON

The profits usually do not come quickly with real estate investments. Yes, you might charge rent to tenants, but often these payments only cover the cost of your mortgage payments or the other costs associated with maintaining an investment property. The big profits come when you sell the property for more than what you paid for it. To hit that goal, though, you usually must wait several years for your properties to increase in value.

LOCATION

Location is key when investing in real estate. Your property probably will not increase in value if it is not located in a community with a growing population, safe, close to transit, and investor friendly. As discussed under the Pillars of Returns section, appreciation in the market value of a property is often a significant part of the return. This means you will have to do plenty of research to find the right investment property in the right location, at the right time.

TAXATION CONSIDERATIONS

One of the important considerations when investing in rental properties is the taxation on capital gains realized over the period of ownership. As of the date of the writing of this guide, 50% of the capital gains is taxed at your personal marginal tax rate. This will certainly affect your ROI (return on investment).

Always consult with an Accountant regarding your tax obligations to have a clear understanding of whether investing in a rental property makes sense financially given all expenses involved including capital gains tax. Depending on your province, also consider taxes like the Property Transfer Tax in BC as well as the Property Flip Tax that appears as though it will be implemented in the near future.

For further information on becoming a real estate investor, please contact:

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MORTGAGE ARCHITECTS
A BETTER WAY

Verification of down payment source requirements may vary amongst lenders. Please only use this info as a general guideline and consult with a mortgage professional or your bank regarding your specific situation and application"