CANADA'S NATIONAL PUBLICATION FOR APARTMENT OWNERS AND MANAGERS

Canadian APARTMENT Magazine

VOLUME 11 / NUMBER 3 / JULY/AUGUST 2014

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Pricing an Investment Property

Guidelines for Passing the Financing Clause

By Chris Seepe

The general consensus among realtors is that financing is the number one reason real estate transactions fail to complete, even among high net worth clients. So why do mainstream lenders decline on a loan, even when the buyer and seller both agree on a purchase/sale price?

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Guidelines for Passing the Financing Clause

The general consensus among realtors is that financing is the number one reason real estate transactions fail to complete, even among high net worth clients. So why do mainstream lenders decline on a loan, even when the buyer and seller both agree on a purchase/sale price?

A common answer to this question is that the buyer, seller and their realtors didn't determine whether the property's cash flow could carry the financing costs before setting the asking price. The higher the price, the greater the amount of money the buyer has to borrow and the greater the carrying costs paid by the property's cash flow.

For the vast majority of investors, it is better to buy three $1 million properties with a 25 percent down payment than to outright purchase one $750,000 property. Even if an investor can afford to pay the full sum in cash, most would prefer to leverage their money. It is a fundamental tenet of real estate investing, after all—to use other people's money—which is why it is common to see a financing clause in a purchase offer allowing the buyer time to obtain a mortgage.

That said, many sellers and their realtors seem to have forgotten this basic tenet. A

recent search for an investment property in a large metropolitan area of Ontario revealed that 26 out of 32 prospective properties were priced such that the property could not carry typical financing costs, assuming today's interest rates and the 25 percent down payment. These realtors (and their selling client) focused solely on the property's net profit (net operating income or NOI) and divided that by the percentage return on investment they thought a buyer should receive—that is, the cap rate (or return on investment assuming an all cash purchase).

There have been many articles published about using cap rate as a principal consideration in assessing the value of an investment property. However, cap rate doesn't reflect cash flow (and financing costs), state of repair of a property (and potential capital costs), geographic growth potential, proximity to amenities (transit, shopping, etc.), crime rate, tenant demographics and other considerations.

Key metrics lenders look at

So what are some of the indicators that show whether a property can carry its anticipated debt load? Lenders look at many variables and ratios, the two key metrics being: Break-even Ratio (BER) and the property's Debt Service Coverage Ratio.

BER (sometimes called the default ratio) tells a lender how vulnerable a property might be to defaulting on its debt in the event that the property's rental income stream should decline. If cash flow (income – (operational expenses + financing costs)) decreases, the owner might miss a loan payment or have to pay for it out of his or her own pocket. BER tells the lender what percentage revenue must decline before cash flow would break even with the loan payment(s) and operating expenses.

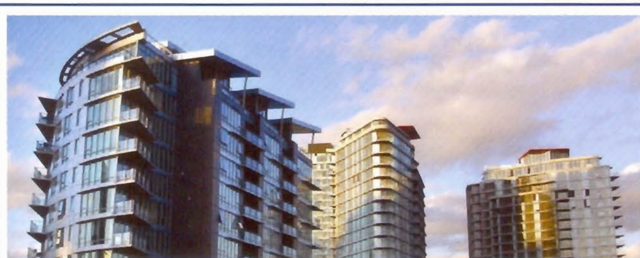
BER = (Debt Service + Operating Expenses) / Gross Operating Income is displayed as a percentage. As a rough rule of thumb, lenders look for a BER of 85 percent or less, because they want the assurance that rents can decline 15 percent before the property's income stream breaks even. The lower the BER, the better it is for the lender.

Lenders use the property's (separate from the buyer's personal) debt service coverage ratio (DSCR) to measure a property's ability to pay its operating expenses and mortgage payments. Debt service is the total of all interest and principal paid on a property's loan(s) in a given year.

DSCR = NOI / Annual Debt Service is expressed as a ratio. A DSCR greater than 1.0 indicates that there are funds remaining after servicing the mortgage, whereas less than 1.0 means there isn't enough income to pay the mortgage. In today's market, many lenders want at least 1.3-to-1 for a commercial loan; the higher the DSCR, the better. However, in both metrics above, this also means more of the investor's money is tied up as equity in a property.

Other lender considerations include a buyer's credit rating, sufficient personal income, small (leveraged) down payment, and/or limited financial reserves. A lower-than-expected appraisal can affect the loan amount too, even if the buyer and seller (and the market) agree on a higher price.

All the above factors should be considered in order to achieve the greatest chance of passing the financing condition – or better still, triggering multiple competitive offers. A low appraisal may occur because of the state of repair of the property, local market, historical factors, or environmental concerns that weren't known or considered.



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CMHC

A common surprise for investors is the lender's discounting of the appraisal price to reduce the amount of the loan they are willing to underwrite in order to mitigate their risk exposure. Additionally, if CMHC is involved, lenders generally use whatever CMHC's "assessed" value is since the loan is then 100 percent insured. However, CMHC's assessed value can be below the purchase price, or even market value.

A common scenario: the buyer believes it has the requisite 25 percent down payment based on the purchase price. CMHC assesses the property at a lower value, making the loan amount lower than it'll insure. This forces the buyer to either add more money to cover the difference, and/or pay a CMHC premium for having a "low" down payment, which can be four to six times higher than the standard rate. Still, the deal fails because the buyer has exhausted his or her financial resources and can't find the additional funds.

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Additional guidelines

There are some additional guidelines that can help establish an investment property's selling price. Each one separately carries little weight but collectively may have a bearing.

Every municipal property tax authority wants to have an accurate value assessment of every property in order to collect property taxes. Assuming they got it right for a particular property, a broad rule of thumb (and the municipality's goal) is that the property assessment is within 20 percent or so of market value.

A property that is priced significantly higher isn't necessarily the wrong price but the reason for the difference should be well-understood. An unhappy side effect of a purchased over-priced property is that the property tax will increase (which means less cash flow and profit). Municipal tax authorities have a mandate to ensure that inspections of properties, especially those triggered by issuance of a building permit issue, are completed on a timely basis so that retroactive assessments and tax can be levied as soon as possible and before statutory limits expire.

There are services available to realtors that collect the historical prices paid for different types of properties. For example, a common metric for multifamily properties is price/door, decreasing in value as the number of doors per building increases. For example, the market norm for 6-plexes may be $100,000/door while 50-plexes fetch $60,000/door. There should be a compelling reason for why a per-door price is far above the norm.

The "one percent guideline" is another quick check. If the monthly gross rent divided by the purchase price is below one percent, then a solid business/financial reason should be found for why this is so.

When setting the asking price of an investment property, cap rates tell part of the story but properly factoring in the lender's loan risk assessment criteria substantially increases the buyer's prospects of procuring "other people's money."

Chris Seepe is a commercial real estate broker and broker of record at Aztech Realty in Toronto, specializing in income-generating and multi-residential investment properties, retail plazas, science and technology related specialty uses and tenant mandates. (416) 525-1558 Email cseepe@aztechrealty.com; website: www.aztechrealty.com.