

## Portfolio Lending vs Transactional Lending A Goal-Oriented Approach

For years, the majority of bankers and brokers in Canada have been trained to look at each mortgage request that crosses their desk as a transaction. That is because the majority of mortgages processed in Canada are for home owners. Over the past number of years however many Canadians have made the decision to choose real estate as their investment vehicle of choice, whether it's to create financial freedom or extra cash flow. For these investors a transactional approach could be costly. Real estate investors know that they will need to make multiple purchases in order to accomplish their goals. What they don't know is that they need to make those purchases with the understanding that each move now impacts the whole portfolio. As such they do not have the luxury of taking a transactional approach to their mortgages. Instead they need to be working with someone who understands how to take a portfolio approach.

The difference between a 'Transactional' approach to lending vs a 'Portfolio' approach is the difference between playing a game of chess at eye level vs looking at the board from above. When you are looking at the board at eye level, you can make a move, but you have no idea how your move may impact the other players on the board. If however, you take a bird's eye point of view, you will be able to anticipate the cause and effect of your move before you make it – thus avoiding the typical mistakes that cause you to hit the 'brick wall'. The difference is simply this; the majority of brokers and bankers have been trained to do a simple task – get you a mortgage. You come to them and say that you have just purchased a property and need a mortgage. If they simply provide you a mortgage as per your request, they are focusing on the transaction – not your portfolio.

A broker or banker, who understands the 'Portfolio' approach, will first and foremost ask you about your 5 year plan. I learned the hard way when I first started working with real estate investors that if I simply took a transactional approach to getting a mortgage, I could inadvertently handcuff my client from getting future mortgages. So I learned to ask 'What are your goals? What is your plan?' And after asking these questions many times over, I discovered that real estate investors have unique issues that homeowners don't. I also realized that they really only have two major obstacles. One is qualifying for multiple mortgages at the bank and the second is being able to come up with enough money for down payments on all of their potential purchases. These two obstacles have a cause and effect impact on each other. What you do on one side of the ledger impacts and affects the other. As such, it is imperative that you take the portfolio approach or 3000 foot view in order to ensure that today's decisions do not negatively impact tomorrow's.

### Transactional Approach:

A common mistake using the transactional approach is where an investor will talk to their bank or broker about buying one or two properties. The client explains that they have a limited down payment and instead of putting all their money on one property would rather use high ratio mortgages to spread it out over two. The bank calculates that they have enough verifiable income to qualify for the high ratio mortgages and funds the two deals. Six months later, the same client comes back with two more purchases and a joint venture partner to provide the down payment, but the bank declines them because their debt service ratios were maxed out on their previous purchases. Their banker then explains that in spite of the fact they 'qualified' for high ratio mortgages on their last 2 purchases, the properties now have negative cash flow so the third purchase puts them over their debt service limits with the bank. In other words, not asking about the client's goals resulted in poor advice.



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## Portfolio Approach:

The same client sits down with a broker who understands the portfolio approach and has a pre-positioning consultation. In that consultation, the broker becomes aware of the fact that the client has a goal to buy 20 single family homes or townhouses over the next 5 years. The broker would then immediately know by looking at their financial statements that it is unlikely the client has enough cash to purchase all of those properties himself so they discuss the use of joint venture partners. The broker also knows that the client will likely have to utilize multiple lenders to accomplish this goal since most lenders have a limit as to how much exposure they want with one client. In addition, the broker will realize that, based on the client's current income, in order to qualify for that many properties, each purchase will need to generate a positive cash flow. This will allow the broker to use the surplus to help qualify for future deals. As such, the next purchase would need to be made conventionally with at least 20% down. Not only will this avoid the cost of high ratio insurance, but it will aid in creating positive cash flow for the client. Since the client already knew that they would eventually need to attract joint venture capital, they structure the first purchase with this in mind. The surplus from the positive cash flow allows them to qualify for their next purchase and their portfolio looks more attractive to future joint venture partners.

As a further step, the broker using the portfolio approach will recommend that the client structure both the mortgage on their principal residence and the one on the rental property with a readvanceable mortgage/line of credit combination. This product, which is offered by various lenders in various forms, is structured in such a way as to allow equity created by paying down the mortgage to be readvanced in the form of a line of credit (LOC). The amount of accessible equity in the LOC will build up every year until there is enough for a future down payment. And of course, when the money for the down payment comes from the LOC on the principal residence, the interest on the LOC is tax deductible.

When you start with the end result in mind and look at your portfolio from a 3000' view, the obstacles become obvious. By simply taking the 'Portfolio Approach' to structuring the mortgage, you can identify the obstacles well in advance and structure the portfolio in such a way as to address the obstacles before you encounter them. Every action you take has an equal and opposite reaction. Understanding the cause and effect that your decision-making process has on the development of your portfolio is the difference between accomplishing your goals and hitting the proverbial brick wall.



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