



Portfolio mortgages

'1.1 rule' puts leverage into hands of commercial real estate investors who own multiple properties

The recent announcement of the 2010 Winter Olympics combined with the advent of historically low interest rates means one thing: More people will be making attempts to enter the Greater Vancouver revenue property market than ever before.

However, my experience as a mortgagee specialist is that most first-time investors fail to get the best advice when venturing into this field and thereby don't take full advantage of all the tools and products that are available in the marketplace.

As an astute investor, your aim is to develop a multiproperty portfolio and for this you will need a plan and professional assistance.

The first key to investing in revenue properties, as with any venture, is to have a clear vision of your goals.

I always tell my clients to start with the end goal in mind and structure everything moving forward so that it is consistent with the end objective.

Maintaining this perspective can not only help you make the right decisions, but could dramatically affect the way you structure your first few deals.

A good example of this is the investor who is just starting out and has built up some equity in his or her home, may have a modest down payment and is looking to eventually have a cer-

tain amount of passive income coming in on a monthly basis.

Three or more properties

An investor such as this would benefit greatly from knowing how to utilize a Rental Cash Flow Analysis, or as I call it, the 1.1 per cent rule. The rule is critical to understand if you plan to have three or more revenue properties.

Essentially, the Rental Cash Flow Analysis that is utilized by some lenders treats revenue properties as a portfolio once a client has three or more. As such you can enjoy much more favourable debt servicing calculations.

The 1.1 per cent rule is actually a calculation of the Debt Coverage Ratio or DCR. The basic concept is quite simple; a lender likes to see \$1.10 of income for every \$1 of expense. The income is based on the rent and the expense is a factor of the mortgage payment, property taxes and condo/strata fees.

What makes this little formula very interesting for the investor on a modest income — or one that can't be verified — is the way it is treated by a lender once you have three or more revenue properties.

The biggest problem or concern most investors have when trying to accumulate multiple properties is with their Total Debt Service

Ratio or TDSR (not to be confused with a DCR). Your TDSR is a formula that calculates the ratio of your debt against your income and this ratio cannot exceed 40 per cent. In other words, you cannot spend more than 40 per cent of your verifiable income on your mortgages, loans, credit card debt, etc.

Lenders may vary on their rental policy, but few, if any, allow you to have a 100 per cent rental offset. It is more common for the lender to take 50–75 per cent of the rental income and add it to your employment income and then calculate the Debt Service Ratio. In many cases, once you get beyond three properties using this formula, the TDSR is often well beyond 40 per cent and investors with modest incomes have to limit their portfolios.

In fact, some lenders will limit purchasers to a certain number of properties and then classify them as commercial borrowers once they have five or more.

The solution

For an investor who finds him or herself in such a situation, tendency may be to cut back on their long term investment strategy. The solution is find and work with a lender that utilizes a Rental Cash Flow Analysis.

When the properties are all laid out you can easily calculate the Debt Coverage Ratio (DCR). If the subject property is 1.1 or greater and the cumulative DCR is 1.1 or greater, the DCR supercedes the need to debt service based on income. As such, once you get to the third property, a DCR of 1.1 or greater amounts to a 100 per cent rental offset and you can keep adding properties without needing a massive income to debt service them.

Understanding this concept has revolutionized the way some investors are approaching the development of their portfolio. It has allowed them to not only add to their existing portfolio, but to negotiate better rates on all their holdings.

An example

Imagine yourself as an investor who has saved up or been gifted a good down payment (say \$80,000) and has normal credit but a modest income (or one that cannot be verified).

You may be inclined to spend it all as a down payment on a single Vancouver property. The problem is you may have trouble qualifying if only 50 per cent of the rent is added on to your income for Debt Servicing.

Alternatively, you could take the \$80,000 and split it up among three smaller investment properties (assuming 25 per cent down on each).

You would then qualify as having three revenue properties on the Rental Cash Flow Analysis and as long as the DCR is 1.1 or greater you would only need enough employment income to service existing debt (mortgage on principle residence, credit cards, etc). Future expansion of this portfolio would only be limited by your ability to come up with the down payment, not your income. In other words, you are using leverage to acquire more property.

An understanding of these concepts and an ability to implement them will allow investors to take full advantage of the current market conditions.

I advise all investors to fully discuss these strategies with their financial adviser and a good mortgage broker, one who understands the concept behind Rental Cash Flow Analysis. ♦

You won't have to rely on income



PETER KINCH

Peter Kinch is a senior mortgage consultant and owner of The Mortgage Centre-Canadian Mortgage Team. Visit his team at www.peterkinch.com