Apartment building portfolios entice preferred financing

MULTI-FAMILY FINANCING

By MICHAEL LEE

One of the main differences regarding qualification for commercial financing versus residential financing is that the borrower's personal income is generally not a factor. From the lender's point of view, the property should be generating enough net income to stand on its own merit.

This is not to say that lenders don't need to see any income from the borrower. They will look at the whole picture and consider all factors in their assessment of a loan request. If the property's income were to be reduced, the lender would want some assurance that the borrower has additional personal income to supplement potential cash flow shortfalls.

Apartment buildings as an asset class are considered stable and low-risk investments, and most commercial lenders are willing to provide great financing for this type of property. Typically, lenders will consider it to be a commercial multi-family property if it is five or more units. Financing can usually be done conventionally, or with **Canada Mortgage and Housing Corp.** (CMHC) insured financing.

Lenders will usually do a maximum of 75 per cent loan-to-value of the appraised value or purchase price, whichever is less. The net income of the property will need to service the loan not just at a one-to-one ratio, but usually, for this asset class, at 1.25 times (also known as a debt coverage ratio of 1.25).

For example, if the monthly mortgage payment is $5,000 per month, lenders will look for the net income of the property to be $5,000 x 1.25 = $6,250 to allow an additional amount of safety.

Lenders will want a current commercial appraisal and Phase 1 environmental report. Some lenders also require a building condition report.

Low-cost loans

The main benefit to obtaining CMHC insured financing is the low interest rates that can be locked in for long-term financing. Because the loan is insured, there is virtually no risk to lenders, so they are able to offer their absolute best rates.

Indicative rates for a five-year term are currently around 2.6 per cent and around 3.4 per cent for a 10-year term. These float with the Canada mortgage bond rate, so they fluctuate daily. Compared to conventional rates, these are usually around a full 1 per cent less.

The maximum loan that CMHC can provide is 85 per cent loan-to-value. Note that the value would be determined by underwriting criteria set out by CMHC. This includes additional expenses, such as a caretaker expense, property management, maintenance and repairs, and appliance reserve. CMHC will also look to its historical records in determining what capitalization rate and vacancy rate to use for the area, which will ultimately affect what the overall value is for the property.

For properties of five to six units, the minimum debt coverage ratio (DCR) is 1.1, which is significantly lower than for larger rental properties.

For larger properties, the minimum DCR requirement is 1.3 for a five-year term and 1.2 for a 10-year term.

Insurance fees tied to loan-to-value ratio

There is an application fee to CMHC of $150 per unit that borrowers have to provide up front in order to have CMHC review the file. There is also an insurance premium that is charged, which will be based on the loan-to-value. This ranges from a high of 4.5 per cent for 85 per cent financing to 1.75 per cent for loans at 65 per cent of value. Both the application fee and the insurance fee can be added into the mortgage, but, as previously mentioned, the application fee needs to be paid up-front first in order to start the process

The amortization would normally be based on 25 years. CMHC also allows you to extend the amortization from 25 years to 30, 35 or 40 years, with a surcharge of 0.25 per cent for each extension of five years (it's rare, however, that CMHC will do more than a 30-year amortization).

NOI used

It should be noted that CMHC will require that the borrower have sufficient net worth and a good credit history. If the borrower is a corporation, a review of audited financial statements may be required.

CMHC does not require a commercial appraisal.

The value of the property is derived from the annual rental income of the property, called the net operating income or NOI for short. This is commonly referred to as the "income valuation approach."

Once you have established the NOI (annual effective gross income minus operating expenses), you then divide the NOI by a capitalization rate to obtain the capital value of that income stream in a given year. A low cap rate translates into a high value whereas a high cap rate translates into a lower value.

The higher the NOI, the higher the value of the property will be. This illustrates the importance of making sure that your rental income and revenue from all other sources (laundry, parking, etc.) are maximized at all times.

Generally speaking, CMHC uses stabilized income (rent levels sustained for one full operating year) at the time of insurance application as substantiated by the property rent roll to determine the gross rental income.

If you are considering the purchase of a multi-family property, contact a professional mortgage broker. They are often able to do a quick income analysis of the property and explore what the best financing options are for you. ■

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Financing for commercial rental property is completely different than financing for residential property. To a large degree, it is a different set of lenders and a different set of lending criteria.