Mortgage Financing Overview For
Rental Apartments

PART 1 – Types of Mortgages

First mortgages fall into two categories:

(A) Conventional Mortgages

These are loans up to 75% of lending value (lesser of purchase price or appraised value.) Pricing of the loan depends on the loan amount involved.

Loans under $500,000 are typically priced at or slightly above the posted residential mortgage rates that you would see advertised in the Calgary Herald or Edmonton Journal.

Loans between $500,000 and $1 million are typically priced based on a spread over Government of Canada Bonds (G of C) for the term selected. Typical pricing for a 5 year term today would be:

> 5.50% G of C Bond
> 1.75% spread
> 7.25% interest rate to the borrower

Loans over $1 million are typically priced based on a spread over Government of Canada bonds for the term selected. Typical pricing for a 5 year term today would be:

> 5.50% G of C Bond
> 1.50% spread
> 7.0% interest rate to the borrower

Advantages of conventional mortgages:

- Faster turn-around time for approval.
- Lenders are usually more negotiable on business terms.

Disadvantages of conventional mortgages:

- Larger down-payment required.
- Interest rates are higher than CMHC insured loans.
- Conventional loans are usually only available in large metro areas such as Calgary, Edmonton and Red Deer.

(*Please note that the interest rates discussed herein are for discussion purposes only and will vary from lender to lender.)

(B.) CMHC insured Mortgages

These are loans up to 85% of lending value (lesser of purchase price or appraised value.) Pricing of loan depends on the amount involved.

Most CMHC insured loans are priced based on a spread over Government of Canada Bonds (G of C) for the term selected. For a 5 year term mortgage, here are typical spreads for various loan sizes:

	5 Yr. G of C Bond	Spread	Gross Rate
Under $500,000	5.50%	1.25%	6.75%
$500,000 to $ 1 million	5.50%	0.95%	6.45%
Over $1 million	5.50%	0.85%	6.35%

The costs associated with a CMHC insured loan are:

- CMHC Application Fee of $150 per unit.
- CMHC Premium based on the loan to value ratio:

Up to 65%	1.75%
Up to 70%	2.00%
Up to 75%	2.25%
Up to 80%	3.50%
Up to 85%	4.50%

Both the application fees and the premium may be added to the loan amount.

Advantages of CMHC mortgages:

- Better pricing.
- Lender competition.
- Lenders will provide financing in most locations including small towns.

Disadvantages of CMHC mortgages:

- Turnaround time is typically 3 to 4 weeks.

(*Please note that the interest rate spreads discussed herein are for discussion purposes only and will vary from lender to lender.)

Part 2 – How lenders analyze debt servicing

Loans are analyzed based on the cash flow of the building. Cash flow is calculated as follows:

Gross Income
<u>Minus Vacancy & Bad Debt</u>
= Effective Gross Income
Minus Expenses
= Net Operating Income (NOI) before debt servicing.

- Gross income is based on actual rents, or on rents achievable in a very short term frame, i.e. rental increase notices taking effect concurrently with funding of the mortgage.
- Current vacancy and bad debt expense of 3.0% is being used in the Edmonton and Calgary marketplaces. *Remember, even at full occupancy there will be "turn-over" vacancy and bad-debt.
- Expenses are a combination of actual expenses such as utilities and property taxes and additional expenses such as management, repairs/maintenance, reserves and advertising.
- Be vigilant on confirming utility, repair and maintenance expenses.
  -bulk metered electricity/individually metered electricity

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Operating Income}}{\text{Annual Debt Service of the Mortgage}}$$

In calculating Debt Service Coverage Ratios (DSCRs) here are typical lender requirements:

Conventional Mortgages: Lenders typically use 9.0% as an underwriting rate if the term of the loan is 10 years or less. If the term is 10 years or more, they may use 8.0% as an underwriting rate. Lenders want to see a DSCR of at least 1.20x (NOI/Annual debt service.)

CMHC Mortgages: CMHC allows the lender to use the market rate of interest. If the term of the loan is 10 years or less, a minimum DSCR of 1.30x is required. If the term of the loan is 10 years or more, a minimum DSCR of 1.20x is required.

Part 3. – Information Requirements

Here is what you will need to document a mortgage application:

- Accepted Offer to Purchase
- Current AACI Appraisal
- Phase I Environmental Report (ESA) satisfactory to lender/CMHC
- Building Condition Report (roof/structural/mechanical)
- 2 to 3 year operating statements for the building.
- Current rent roll and 12 month vacancy history.
- 2 to 3 years operating statements for the borrowing company.
- Personal Net Worth Statements (PNWs) for the principals (including verification of major assets – bank statements, equity verifications).

Note: As a very general rule of thumb, the combined personal net worth of the applicants based on cash and verifiable equity in other real estate should be at least 25% of the loan amount being requested.

Part 4 – Costs and Timelines for a typical 24 suite walk-up apartment building.

We suggest that you confirm with your lender beforehand that your report provider is acceptable to them. At that time you can also request a fee quote.

For a 24 suite apartment building transaction here are some "ballpark" costs and timelines:

Appraisal Report	\$1,200 to \$1,500	(4 week turnaround)
Phase 1 Report:	\$1,200 to \$1,500	(1 week turnaround)
Building Condition Report:	\$500 to \$1,500	(1 week turnaround)
Lender Fees:	Get quote from lender.	
Legal Fees:	Get quote from lender/solicitor.	
Refundable Standby Fee:	1% to 2% of loan amount	

REIN
Meeting

“Mortgage Financing for Rental Apartments”

Sheraton Cavalier
Calgary AB

Saturday
April 6, 2002

Presented by George Hilton

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