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Pricing an investment property to pass the financing clause

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Sales reps generally agree that financing is the No. 1 reason real estate transactions fail. Why do lenders refuse to approve a loan even when the buyer and seller both agree on a purchase price?

Often, sellers and their agents didn't determine whether the property's cash flow could carry the financing costs when they set the asking price. The higher the price, the greater the amount of money the buyer has to borrow and the greater the carrying costs, which are paid by the property's cash flow.

For most investors, buying three $1 million properties with $250,000 (25 per cent) down payment on each is better than purchasing one $750,000 property. Even if they could afford to pay all cash, most investors still want to leverage their money. It's a fundamental tenet of real estate investing – use other people's money.

Yet many sellers and their agents seem to have forgotten this basic tenet and almost no listings state cash flow (before taxes, or CFBT). While searching for an investment property recently in a large metropolitan area in Ontario, I looked at 32 prospective properties. Twenty-six (81 per cent) were priced such that the property could not carry typical financing costs, assuming today's interest rates and 25 per cent down.

Many commercial listings focus solely on the property's net profit (net operating income or NOI) and agents divide that by the percentage return on investment they think a buyer should receive; that is, the cap rate (assuming an all-cash purchase), to determine a property's price. However, the property's value for most investors is whether the net profit can carry the financing costs (cash flow) and most listings don't state cash flow (before taxes).

Cap rate is a principal consideration in assessing investment property value but it 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), crime rate, tenant demographics and other considerations.

So, what indicators help determine whether a property can carry its anticipated debt load? Lenders look at many variables and ratios but two key metrics are break-even ratio (BER) and the property's (not the buyer's) debt service coverage ratio (DSCR).

BER 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 decreases, the owner might miss a loan payment or have to make the payment themselves. 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. Generally, lenders want 85 per cent BER or less, meaning rents can decline 15 per cent before the property's income stream breaks even; the lower the BER, the better for the lender.

Lenders use the property's (separate from the buyer's personal) DSCR to measure a property's ability to pay its operating expenses and financing costs. 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 enough funds remain 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.

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. 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.

If CMHC is involved, lenders generally use whatever CMHC's "assessed" value is since the loan is then 100-per-cent insured. However, CMHC's assessed value is often far below the purchase price or even market value. This could be because CMHC has been mandated by the federal government to curb the disturbing rising debt load trend among Canadians that has occurred during the last decade; and/or wants to trigger the premium it receives for "high-leverage" loans. As a monopoly, CMHC has no competitive pressures on its pricing.

A common scenario: the buyer believes it has the requisite 25-per-cent down payment based on the purchase price. CMHC assesses the property at a much lower value, making the loan amount lower that it'll insure. This forces the buyer to either add more money to cover the difference, and/or pay a hefty 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 maxed out their financial resources and can't find the additional funds.

There are some additional "sanity" checks (guidelines) that can help establish an investment property's selling price. Each one separately carries little weight but collectively they may have a bearing.
Municipal property tax authorities strive to assess property value within 20 per cent or so of market value. A property that is priced significantly higher isn't necessarily wrong but the reason for the difference should be well-

understood.

Services are available that collect the historical prices. A common metric for multi-family properties is price/door. Six-plexes may go for $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-per-cent guideline” is another quick check. If the monthly gross rent divided by the purchase price is below one per cent, a solid business/financial reason should be found for why this is so.

All the above factors should be considered to ensure the greatest chance of passing the financing condition, or better still, triggering multiple competitive offers. 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.

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