Financing traps to avoid

***Dalia Barsoum* and *Enza Venuto* examine the world of real estate financing from a lending adviser's perspective**

As lending advisers that cater to real estate investors, we have seen many pitfalls that real estate investors make when it comes to financing their real estate portfolios. Some of those are fatal and can restrict the investors from growing their portfolio to the extent desired or may impact their ability to service the mortgage payments.

In this article, we will share some of those traps so you can avoid them.

TRAP 1 Lack of planning and goal-setting

Not being clear on your goals such as why you are investing in real estate, how much cash flow do you expect on a monthly basis from your investments, how many properties are required to help you get where you want to be, are you after short-term or long-term profits and what types of properties are suited for your portfolio, means that you will be tempted to buy anything and everything, only to realize at the end that you are somewhere you did not intend to be.

Upfront planning and ongoing review of your plan will help you stay focused, will save you money and will increase your chances of success. If you are planning on purchasing multiple investment properties, build a relationship with a lending adviser who has experience in financing real estate portfolios and who can help you develop a long-term roadmap. It is imperative to speak with your adviser early on in the process so he/she can help you acquire and structure financing in a manner that supports your short- and long-term investment goals and ensures that you don't hit a wall when it comes to financing the rest of your deals.

TRAP 2 Not getting pre-approved

When buying a non-commercial property (up to four units), being pre-approved gives you a general idea of how much you can afford to borrow. It means that the lender has verified your information and credit rating and agreed to provide you with a specific amount of money. Investors are in a much better position to go house hunting when knowing how much they can afford and have financing for.

TRAP 3 Putting too much emphasis on interest rates

While lowering the costs associated with financing is crucial, a lower interest rate alone does not always equate to the best loan. For example: a lender offering you a 6% interest and 35-year amortization will put in your pocket thousands in annual cash flow relative to another lender offering you a lower interest rate of 5% and shorter amortization of 20 years.

In addition to amortization and the interest rate, investors should consider other aspects of the loan such as additional fees associated with commissions (especially in commercial loans) and penalties as well as the attractiveness of the loan terms.

TRAP 4 Not having a relationship with a qualified broker

When it comes to financing real estate investments (especially if you are planning on purchasing more than one property), building a long-term relationship with a qualified mortgage broker specializing in financing real estate investments is crucial. In the mist of the tight timelines of deal negotiation, some investors may default to their usual bank branch, a friend or a family member who is in the lending business or a referral by their Realtor to help finance the deal. In many cases the deal does get financed, however without the lender's or agent's understanding of the investor's long-term game plan or because of the agent's limited access to lending products and private financing, financing may be unintentionally structured in a way that restricts the investor's ability to execute the plan as initially intended or that increases the overall financing costs of the portfolio.

TRAP 5 Getting excited about 100% financing

While one of the great advantages of real estate investing is leverage (i.e. utilizing borrowed money for asset acquisition) as it increases the investor's return on investment, very high leverage carries risks that investors often oversee when going down that path.

There are no lending programs in Canada at the moment that support 100% financing for investment properties. Investors who want to finance 100% of their purchase may be able to do so through various strategies such as: seller financing (only if the lender of the first mortgage allows it), using equity from an existing property or using funds from a line of credit.

The risks of 100% financing are twofold: First, when you are financing 100% of the purchase price, your payments will be higher and if you have a second mortgage payment to add to a first mortgage, your payment will be even higher. Be sure your rental income will cover the entire monthly payment. Second, if your investment time horizon is short (less than five years) and you are buying in a market cycle where real estate prices are declining, you could have a mortgage amount that is more than the value of the property.

TRAP 6 Not analyzing the property with a magnifying glass

We have seen borrowers get into trouble of having to hold properties with significant negative cash flow or not being able to service their mortgage payments because they bought without factoring in the proper reserves for maintenance, capital improvements, and vacancies or overestimated the rental income or underestimated expenses.

Build in a due diligence phase as part of your purchase agreement, which gives you the time to validate your assumptions about rental income through reviews of rent rolls and leases and validate your assumptions about expenses through reviews of existing expense receipts and tax assessment rolls. Moreover, factor in any extra maintenance / repair costs that may surface during inspection and a reasonable reserve for vacancies and rent collection. Finally, consider running a worst-case scenario of your analysis factoring in any potential interest rate increases over the holding period.

Enza Venuto, AMP, CMP and Dalia Barsoum, MBA, FICB are lending advisors with StreetWise Mortgages and real estate investors with over 35 years of combined lending, financial and investment experience who provide advisory services and lending solutions tailored to Real Estate investors.