A DIFFERENT SLANT ON ENERGY EFFICIENCY ("**EE**")

Most consumers are familiar with the various promotions, incentives and general encouragement to take measures that lead to energy conservation and a reduced carbon footprint. An obvious example is the mandated requirement for car manufacturers to produce more fuel efficient vehicles over the next several years.

Apartment investors, in particular, have been exposed to numerous initiatives geared to savings in the use of water, fuel (heat) and hydro. Most are justified on the basis of rebates available to owners and the "payback period" – the amount of time it takes to recover the cash outlay required to install the **energy efficient ("EE")** equipment via reduced operating expenses. Generally, the payback period is years. The payback period is influenced by the cost of utility consumption and which utilities are most affected. For example, not all buildings consume the same amount of water, fuel or hydro. So the justification is not standard. It is case-by-case depending upon the utilities consumed at the building. Obvious differences are evident in a building heated by gas as opposed to electricity (hydro). The suite count will also impact results. For example, a building of 40 bachelor units will consume less in utility costs than a building with 40 two bedroom units.

Regardless of the payback period, the conversion to EE equipment is worth it because of the long term savings, reduced maintenance required on newer equipment and the improved marketability of a building that has been upgraded to modern standards.

However, there is another perspective on the rationale to convert to EE equipment and it is connected to the availability of CMHC insured financing for apartment investors. In the current market, and indeed over the last 5 years or so, CMHC insured mortgage loans have been the financing solution for most investors.

On new CMHC insured loans, for either purchases or refinances, borrowers are able to implement a strategy that permits them to install EE equipment as part of the new loan.

A recent deal is a case in point. The borrower acquired a 44 unit building in the western GTA that had not been upgraded with current EE equipment. As part of the acquisition, the borrower wanted to install new toilets, tap aerators, low flow shower heads (water efficiencies), radiator reflector panels (gas efficiencies) and new lighting (electricity efficiencies). The total cost of the new equipment was approximately $43,000. The borrower was required to install the equipment at his own expense. Upon receipt of evidence that the equipment was installed and paid for, a second loan advance was made in the amount of $180,000. The second advance of $180,000 was made because EE measures would produce a reduction in expenses – and an increase in net income – that permitted a larger loan than would have been available without these utility expense reductions. In this case, energy costs were reduced by about 18%. To be clear, the $180,000 is part of the mortgage loan and has to be repaid over the amortization period of 25 or 30 years. On the other hand, this amount is substantial and effectively reduced the amount of equity the borrower needed. In the end, he also had an improved EE building.

There are some key points and timing issues to consider if a borrower is contemplating this:

1. The borrower has to decide to pursue this course of action at the time of application for mortgage insurance.
2. A report is required from an authorized consultant. The report will identify the reduction in energy **consumption** as well as costs.
3. The EE equipment that is required to address the issue is identified and estimates of cost are provided by the consultant.
4. The borrower has the equipment installed and paid for. The time allowed for the installation is about 4-6 months depending upon the nature of the work.
5. The consultant provides confirmation that the EE equipment that was recommended has been installed and reconfirms the projected reduction in energy consumption.
6. The lender forwards the report to CMHC and recommends that the relevant conditions in the mortgage insurance approval have been satisfied and the advance of additional funds is warranted.
7. CMHC authorizes the lender to release the second advance of funds.
8. The borrower is also able to obtain a partial rebate of the CMHC insurance premium.

As mentioned above, this option is available on new CMHC insured loans. Since EE is here to stay, prudent landlords might want to consider this approach to funding these investments in the property.

ARE YOU FOLLOWING THE BOND MARKET?

As regular readers of the Mysak Realty Newsletter are aware, I have often encouraged investors to remain current with events in the bond market. Bond market interest rates (referred to as "bond yields") are the major influence on mortgage rates. Bond yields are subject to rapid and wide swings. A borrower who considered a loan a few months ago might be surprised to see that 10 year mortgage rates have varied by as much as 35 basis points (a basis point is one one-hundredth of one percent i.e. 0.01%) between late November 2012 and mid March 2013.

Interestingly, many investors assume that current rates will remain the same because the press confirms this on a regular basis. However, the rate that is most often referred to in the press is the Bank Rate, which is administered by the Bank of Canada, our central bank, and is essentially the cost of money for one day. Prime rates at banks are influenced by the Bank Rate. This rate has negligible influence on 5 and 10 year bond yields and, in turn, mortgage rates. This makes sense: factors influencing a 24 hour cost will be different from factors influencing a cost that covers a ten year period.

First National offers a daily bond market summary, via email, that also provides rates in effect on that day. This allows apartment investors to stay up to date with news and data that affect rates on a daily, weekly, monthly, etc basis. It is a useful tool for apartment investors who want to stay in touch with issues and events that will affect the availability of capital to finance their property investments.

Please contact me at 416 593 2918 or via email at dru.mcauley@firstnational.ca and I can have it delivered every day, usually before noon, to your in box. The daily update is usually a few paragraphs and can be read quickly.

SPEAKING OF CMHC……..

In the Spring 2012 issue of the Mysak Realty Newsletter, I mentioned that CMHC had fallen under the supervision of the Office of the Superintendent of Financial Institutions ("OSFI"), which is the federal regulator of financial institutions in Canada. Most mortgage market participants have monitored developments at CMHC for new policy directives as a result.

To date, there have not been many meaningful changes – it seems to be business as usual for apartment investors. There has been a requirement for a little more due diligence with respect to some stages of the approval process. Frankly, these are simply prudent underwriting measures that most lenders have been observing.

Considering the important role that CMHC mortgage insurance has in the apartment industry, most investors would be well served to stay informed of any new policy developments.

Dru McAuley is Assistant Vice President, Commercial Lending at First National Financial LP, a leading lender of CMHC insured mortgages on multi-unit properties. First National also provides short term or conventional financing in all segments of the real estate market. He would be pleased to answer any questions or discuss this article. Dru can be reached at 416-593-2918 (toll free 1-800-465-0039) or dru.mcauley@firstnational.ca.