Do You Need a Two Stage Financing Strategy?

Most apartment investors automatically select a mortgage option that is based upon the lowest rate available at the time for either a five or ten year term

While this makes intuitive sense, the fact of the matter is that there are frequently other considerations involved in making a prudent decision.

Making the correct decision means identifying the type of apartment property under consideration. There are basically two types of buildings:

1. Buildings that are functioning properly and achieving consistent income. Let's call this type of property a "yield play" because it generates a steady return on investment.
2. Buildings that need upgrades both in terms of physical condition and the rent levels. These properties can be considered turnaround situations or "growth plays".

So when is the lowest rate available a wise choice? Fixed rate, long term financing is typically called for when the property is a yield play - operating at a maximum level in terms of revenue, expenses and building condition. This is referred to as "stabilized operations". The majority of apartment acquisitions fall into this category.

However, investors make a common mistake when they choose this option for a property that is not yet stabilized and is, in fact, a growth play. This often occurs in a purchase transaction. On closing, the financing available is determined, in part, by the amount of net income available to service the mortgage loan. In addition to that, funds could be retained by the lender (a "holdback") to address building condition deficiencies. Lenders will not offer aggressive loan amounts for properties that are sub-standard and poorly maintained.

Another problem might exist with the level of the rents. Not all properties are achieving market rents, which can be difficult to achieve if the property is in poor condition.

Many investors seek exactly this sort of opportunity wherein they can acquire a building that needs physical improvements and also offers the prospect of achieving higher rents. Such a property would typically be purchased at a discounted price that reflects these value considerations. Since poor building condition could limit the amount of the loan available, investors dealing with these types of assets might want to consider a strategy that features a two stage financing strategy. This involves obtaining a conventional loan on a short term, floating rate basis that is open for prepayment in full. Such scenarios often feature a second mortgage (i.e. a vendor take-back or private mortgage). The plan here would be to improve the property and rent levels, and then obtain long term, fixed rate financing for a larger amount when the property is stabilized and worth more. A typical timeline for completing this type of project would be 3 to 9 months (the "execution period") on medium sized buildings. This strategy has worked well for

investors recently due to continued low interest rates, cap rate compression and upward pressure on rents combined with low vacancy rates.

Another scenario that might call for a two stage strategy might involve adding additional units, converting unused space (i.e. party rooms, utility or storage rooms) to new rental units, achieving income growth via reduced expenses (i.e. reduced utility contracts), new revenue sources (i.e. cellular transmission leases) or the installation of energy efficient equipment. All of these measures add value to a property.

Although the overall rates in financing two stage deals exceed long term rates, the cost is worth it if the result is a larger loan at the end of a comparatively short execution period. Current low interest rates, which are forecast to be available for a while yet, lend support to the strategy.

As an example, a client acquired a property about one year ago and applied for a long term, CMHC insured mortgage loan. The loan amount available was much less than anticipated due to building condition and rent levels. The client elected to go with short term financing that is fully open for prepayment without penalty. He proceeded to complete a substantial (and much needed) renovation. The building became more desirable for tenants and rents were increased. The client added value and the loan available now is approximately twice the original amount.

The point here is to demonstrate that financing solutions can be designed to reflect the specific challenges inherent in certain types of properties. The correct option is one determined by building type (yield or growth) and the investor's investment goals.

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