Investors Guide: Financing Residential Real Estate

US Real Estate is the safest investment in 2023. Why?

- Homeowners have 44 times a higher net worth at retirement than renters do.

- Very few market analysts will go out of their way to say that real estate is a "bad" investment. Some are saying it's a bad time to buy real estate, because *"the crash is coming."* Zero data supports a true real Estate crash coming.

- Inflation is 8% & you've got to do something with your money. Cash in the bank is losing value at 8% per year. The *best* savings account interest rates are around 0.5% right now… A savings account is actually a losing account.

- We are headed into a recession in 2023/2024. <u>Home prices have increased in every single recession since the early 1900s</u>. Obviously 2007 was different, but that was a mortgage driven recession, led by subprime lending, which doesn't exist anymore. The stock market is already volatile and is getting destroyed daily.

- Home values are set to increase on average 18% in the next 5 years.

- Mortgage rates are still well below the actual inflation rate. Make The bank pay the depreciation with their money, not yours.

- 1-3 years from now, rates will be lower and you'll be able to refinance to a rate several points lower (and take cash out).

- Conventional loan amounts are higher than they've ever been - making it the first time ever people have been able to borrow this much money at a normal, conventional interest rate.

- If you still want more proof, look at who's buying the homes around you - Hedge Funds have been buying real estate like crazy because they know home values will continue to go up. 1 in 5 houses were bought by an investor in 2033.

Glossary Terms:

Residential Real Estate: 1-4 Unit and Condominiums. Single Family, Duplex, Triplex, Quadplex. Anything 5 units + is considered commercial Real Estate**.**

Three parts of Mortgage Approval:

1. Down Payment
2. Credit
3. Debt-to-Income (DTI) Ratio derived from Employment History

Debt-to-Income (DTI) Ratio:

It may seem daunting but DTI is actually very simple to calculate. Your DTI is your *Monthly Debts / Monthly Income*. Monthly debts are any payments that show up on your credit report: Student loan payments, Minimum credit card payments, Auto loans, Personal loan payments + Housing expenses of the property you're purchasing - **P**rincipal, **I**nterest, Real Estate **T**axes, **I**nsurance (**PITI**), Mortgage Insurance & HOA fees. Other living expenses NOT on your credit report, like; Auto & Health Insurance, Food, Utilities, - DO NOT go into your DTI. Your financial planner may care about these, but your Loan Officer does not.

49.999% DTI is generally the maximum DTI allowed for mortgage approval. FHA & VA loans (must be primary residences) *may* allow for up to 56% or higher DTI, but it is completely dependent on credit history, down payment and several other qualifying factors. You have to be under 49.9% DTI, but ideally you want to be closer under 45% DTI.

Here's a simple scenario calculating DTI, note ***you will never need to calculate your DTI, this is just if you're curious. Your Loan Officer & Underwriter is responsible for calculating your DTI:***

- $120,000/ year in income / 12 months = $10,000/month.
- $10,000 X 45% = Total allowable monthly debt, including future mortgage payment = $4,500/mo.
- If your future mortgage payment is $2,000/month.

- There's room for a maximum of $2,500 in other debt like: credit cards, auto payments, student loan payments etc…

DTI gets a lot more complicated with the more real estate you own. If you own multiple rentals titled in your personal name, your Loan Officer will have to document: **Full PITI mortgage Payment + HOA** (if applicable)**,** from EACH property. **<u>However, you do not count real estate titled in an LLC in your DTI.</u>**

Different Investment Property Loans (Non-Owner Occupied)

Conventional Loans:

Conventional loans account for 80% + of all financed real estate for a good reason: You're *almost* always going to get the best financing terms with Conventional Financing. The loans themselves are issued by private lenders, however, they are sold on the secondary market, meaning they all have the same standard underwriting guidelines so they can be bought and sold uniformly to investors.

Income Requirements: DTI <u>must</u> be under 49.9% to qualify.

Self-employed: You'll need to provide your last two years of Federal Tax Returns.

- Note, if you own more than 25% of a business you are considered self employed, whether you pay yourself with a W-2 salary or not.

Employed: You'll need to provide your last two years W-2s and last two pay stubs.

- Note, If you earn commission, tips, bonuses or over time - It will be averaged over the past two years.

Quick points:

- **Credit score down to 620**
- **Max DTI of 49.9%**
- **Down payment must come from yourself or a business you own - No gifts allowed.**
- **Conventional loan amount is $726,200 in most counties in 2023.**
- **Up to 10 properties financed with conventional loans**
- **Usually Fixed Rate Mortgages amortized over 30 years**
- **No prepayment penalties (PPPs)**
- **Non-warrantable condos not okay**
- **Title in LLC or Personal Name**
- **Cash Out Refinances: 6 month waiting period after purchase date to be eligible to use new Appraised Value, if purchased with cash.**

Down Payment Requirements:

1 Unit (Single-Family Home) and Condominium Investment Properties:

- 15% Down Minimum, however it's much more common to put 20% - 25% down and a more favorable interest rate is awarded with a higher down payment.

2-4 Units (Duplex, Triplex, Quadplex) Investment Properties:

- 25% Down Minimum.

DSCR Loans (Debt-Service Coverage Ratio):

DSCR loans are the 2nd most popular way to finance investment real estate. There is no income verification, rather the loan qualification is based on the properties cash flow.

DSCR Calculation: Appraiser’s assessment of Fair Market Value of Rent / total PITI Mortgage payment.

- **DSCR ratio down to .75 is acceptable, but much more favorable rates are available with DSCR ratios of 1.0+ (when the mortgage payment = the expected rent)**

Quick points:

- **Credit score down to 620**
- **No income docs or job history documented**
- **DSCR ratio takes the place of DTI**
- **Down payment may partially come from a gift donor (check with your Lender first)**
- **Max loan amounts vary from $1-2 Million**
- **No limit on # of properties financed**
- **Title in LLC or Personal Name**
- **DSCR < 1.0 requires 12 months of reserves.**
- **Interest-only options available**
- **Fixed Rate Mortgages and Adjustable Rate Mortgages (ARMs) amortized over 30 years**
- **Prepayment Penalties (PPPs) required (usually 1-5% of outstanding loan amount for 1-5 years)**
- **Don't usually need to document other Real Estate owned.**
- **Non-warrantable condos sometimes okay**
- **Cash Out Refinances: 6 month waiting period after purchase date to be eligible to use new Appraised Value, if purchased with cash.**

Down Payment Requirements:

1-4 Unit and Condominium Investment Properties:

- 20% down, sometimes 15% down.

<u>Portfolio Loans:</u>

Portfolio loans are loans issued by a bank that dont get resold on the loan on the secondary market (like with conventional mortgages). Rather, the bank keeps the loan on its books, or in its "portfolio."

Quick points:

- **No minimum credit score**
- **Credit score doesn't affect interest rate**
- **Max DTI of 44%**
- **Title in an LLC or Personal name**
- **Interest-only options available**
- **Adjustable Rate Mortgages (ARMs) only.**
- **Prepayment penalties (PPPs) required (usually 1% of original loan amount for 1-5 years)**
- **Non-warrantable condos sometimes okay**
- **Cash Out Refinances: 12 month waiting period after purchase date to be eligible to use new Appraised Value, if purchased with cash.**

Down Payment Requirements:

1-4 Unit and Condominium Investment Properties:

- **20% down minimum**

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Rehab / Renovation Loans

- **10% down**
- **Perfect for financing hurricane flooded houses**
- **NO CONTRACTOR APPROVAL REQUIRED**

Construction Loans

- **10% down**
- **Land equity counts towards down payment**
- **NO BUILDER APPROVAL REQUIRED**

Vacant Land/ Lot Loans

- **25% down < than 5 acres**
- **35% down > than 5 acres**

Rental Income to offset DTI

This is where it gets tricky and you should really leave it up to your Lender.

Future rental income for the <u>Rental Property you're purchasing</u>: 75% of the Appraiser's opinion of fair market value of future rent will be used to offset your DTI.

Long-term rental income for the <u>Rental Property you already own</u>: Must have a signed long-term (12 month) lease & Security Deposit. Short term, month-to-month, AirBnB, VRBO etc.. income DOES NOT COUNT. EVER.

Rental property purchased *<u>in the same tax year:</u>* *Only needs:*

- Signed 12 month lease & Security Deposit - 75% of the monthly rent will be used as rental income to offset DTI.

Rental property purchased *<u>in the previous tax year:</u>* *Needs both:*

- Signed 12 month lease & Security Deposit -
- Past year of net rental income, claimed on Tax returns (net/ claimed, meaning paid taxes on) will be used to offset DTI. Prorated for the # of months owned.

Types of loans:

We're talking residential financing here, meaning: Condos (1-unit in a condo building), Single Family (1-unit), Duplexes (2-unit), Triplexes (3-unit) and Quad-plexes (4-unit).

Anything over 4 units is considered commercial and requires commercial financing.

There's 3 types of residential loans:

81% of mortgages: Conventional

18% of mortgages: FHA - USDA - VA - "Government backed loans"

1% of mortgages: "Other" non-traditional loans

Conventional:

- **Most common type of mortgage.**
- ***Almost* alway the best deal if your credit is 700+**
- **Mortgage Insurance (MI) with less than 20% down**
- **Interest rate & MI heavily depends on credit**
- **Primary Residence, 2nd/ Vacation Home, Investment Property**

FHA: Federal Housing Administration - Government backed

- ***NOTHING* to do with being a *First Time Homebuyer.***
- ***BUT* 83% of FHA loans are first-time home buyers**
- ***HAS* to be primary residence.**
- **Interest Rate and MI not as dependent on credit.**

Reasons why you would go FHA and not conventional:

- **If your credit score is below 690-700 and you don't have 20% to put down, then you will likely get a better deal with a conventional loan.**
- **A higher Debt-to-income (DTI) ratio.**
    - **FHA can go up to 56%**
    - **Conventional can go up to 49.9%**

USDA: U.S Department of Agriculture - Government backed

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Residency:

- **Primary Residence, 2nd/ Vacation Home, Investment Property**

Down Payment:

Conventional:
- **Primary Residence - 5% down 3% down if your a First time Home Buyer**
- **2nd Home/ Vacation Home 10% down**
- **Investment - 15% down**

Owner Occupied Investor (buying as a primary and renting it out)

Buying a primary residence is always going to allow for the lowest down payment requirements and lowest rate.

The most common house hack is: Buying your first primary residence as a multi-family home with an FHA loan putting 3.5% down - living in one unit and renting out the other unit(s).

Closing costs:

DPA

Scenario:

Husband and wife own 4 investment properties together joint on title.

Two mortgages are only in husband's name

Two mortgages are only in Wife’s name.

Wife is buying another investment property – Can we exclude the two investment properties with mortgages in husband's name from her DTI?

Response: Yes, if she is not on the mortgages, you don’t have to count the mortgage payments. Since she is on title though, I’d still count taxes against her and possibly even the insurance (just to be safe)