Is rent-to-own right for you?

Rent-to-own can be a lucrative option for the astute investor. To help you minimize your risk, our experts will guide you through the nuts and bolts of this strategy, in this first instalment of this informative series

A strategy that has gained popularity recently is rent-to-own, whereby a tenant rents a property for a designated time period with an "Option" to purchase it in the future at a pre-determined, appreciated price.

Whether this is the right investment strategy for you depends upon more than the promise of a generous return on investment. As with any investment opportunity, it is important to assess what the potential returns are relative to the risks involved, and most importantly, how to manage those risks. It's also important to understand the rules that govern the transaction, including the implications of being a lender versus being a landlord, the difference between loaning money versus investing in people, the difference between the goal of capital appreciation versus monthly cash flow, and, of course, the tax consequences of active versus passive income.

Perhaps the most pressing question is whether you are willing to become a landlord and perform the associated roles and responsibilities as mandated by the Residential Tenancies Act. Rent-to-own is a re-invention of a traditional rental business and if structured properly can provide distinct performance incentives to the tenant/buyer in return for their fairly significant upfront investment toward the future purchase of a home. In successful models, we've observed that there is a balance between the risk/reward ratio for both the investor and the tenant; enough so that many of the problems that plague traditional landlords and require arbitration by the Landlord and Tenant Board are significantly mitigated. We believe that the implementation and management model is the critical element that will make this investment strategy a success for all of the parties involved.

We also think it's important to assess whether the human element is relevant to you, because investing in rent-to-own is as much about investing in people and their dreams as it is about investing in real estate. In order to be a success, the tenant/

We also think it's important to assess whether the human element is relevant to you, because investing in rent-to-own is as much about investing in people and their dreams as it is about investing in real estate

WHAT IS A RENT-TO-OWN STRATEGY?

Also called a Lease Option, a rent-to-own has two main components

The Tenancy Agreement

Often called a lease or rental agreement, the tenant rents the property from the investor using a customized rental agreement that specifies a rental term typically between one to three years, but up to five years. During this term, the tenant pays an amount in addition to market rent called a rent rebate, which is essentially a 'forced savings' amount applied toward the tenant's eventual down payment. The amount of the 'forced savings' portion is generally the difference between the maximum monthly rent payment that the tenant can afford and the prevailing monthly market rent. This amount also represents cash flow that can be utilized by the investor until it is rebated back to the tenant/buyer at the end of the rental term. In many cases, the landlord/investor requires the tenant to accept some additional responsibilities; such as sharing or absorbing maintenance and its associated costs.

A Purchase Option Agreement

Among other things, this agreement outlines the rights of the tenant/buyer to purchase the property from the investor at the end of the rental term at a pre-determined price. The purchase price, property appreciation factor, roles and responsibilities of the buyer and investor, the terms for default, extensions, assignment rights and inspection clauses are included. By doing so, the tenant/buyer knows exactly what to expect and the investor knows upfront what their exit strategy and estimated profit will be.

Finding the Right Tenant Candidate

A typical tenant/buyer is someone who would like to own a home but who either lacks the necessary credit score required to get a mortgage on their own or who has the monthly income necessary to support a mortgage payment but who doesn't have the down payment of 5%-20% required by conventional lenders. A good candidate is someone with proof of regular and adequate income, who has some money saved toward their eventual down payment. The tenant/buyer will be required to provide an 'option consideration' of at least 2.5% -5% or more, depending upon the investor's risk assessment.

Pre-Qualifying the Tenant

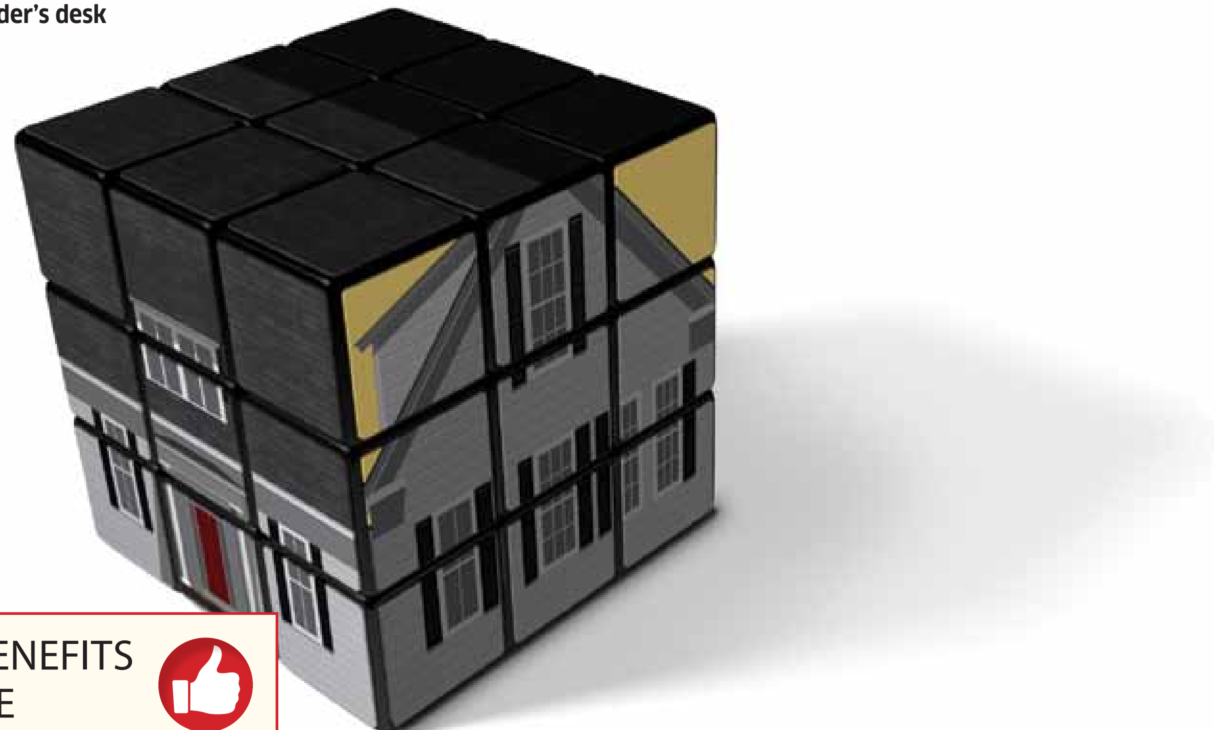
This is a crucial step in order assess the tenant's credit situation and to determine whether they meet the necessary conditions for success. It is essential to have a certified mortgage professional examine a) Why the tenants are in the financial situation they are in b) Whether they have the means to change their situation c) How long, realistically, it will take them to qualify for a mortgage? This examination will determine the length of the rental term, identify the rent payment they can afford, establish the maximum purchase price for the home, and factor in the affordability of their eventual mortgage payment.

Finding the Right Property

Ideally, the investor will find the tenant first so that they have the opportunity to choose the home of their dreams, that fits into their ideal price range and so that they have strong emotional investment in the process. The investor can certainly put some boundaries around where they wish to invest and they have the ultimate approval regarding the purchase of the property. Investing in cities with strong economic growth and steady rental demand are important considerations since both the investor and the tenant/buyer benefit from strong property appreciation.

The Sale

On the option date, the tenant/buyer has the option to buy the house at the agreed upon price, or they can choose to walk away. In most cases they will lose their option consideration and rent rebates if they choose not to buy the house, as these amounts will be used by the investor to liquidate the property.



THE BENEFITS TO THE INVESTOR

- Helping others while making a lucrative financial investment
- Reduced operating costs associated with maintenance, advertising and vacancies, resulting in stronger profit
- Having a tenant with a vested interest in the upkeep and improvement of the property
- Predetermined exit strategy and projected profit
- Saving on real estate sales commissions

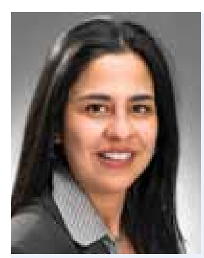
DISADVANTAGES FOR THE INVESTOR

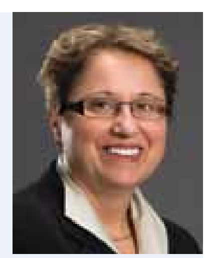
- Giving up any appreciation above the option price
- The property is tied up during the option term as the investor does not have the flexibility to sell it
- The portfolio turn ratio is high relative to a buy-and-hold strategy, as the investor doesn't hold a rent-to-own property for more than a few years and will need to replace that investment

buyer must be screened properly by qualified individuals who care as much about the tenant's potential for success as in protecting the investor's interests. The consistent element within the successful transactions we've observed is that there is always a certified mortgage professional who completes a thorough evaluation of the applicant's financial picture and helps the investor determine their eligibility for a rent-to-own. Quite often there is also a certified financial planner or counselor, who works with the tenant/buyer throughout the rental term to help them stay on track. This process protects both the tenant/buyer and the investor and will help set the stage for a successful outcome.

A prospective investor must ask themselves what their highest priority is for their capital. Unlike buy-and-hold investments where capital appreciation over the long term is the goal, rent-to-own has a relatively short time horizon and therefore lower capital appreciation, but has the potential to provide lucrative month-to-month cash flow, with an opportunity for tax deferral on a portion of it. Consultation with your financial and accounting team is crucial in order to plan the most beneficial tax strategy.

In general, one of the significant tax advantages of investing in a rent-to-own is that the return is taxed as 'active income,' or more specifically from actively managing a property. Not only is this tax rate typically lower, there are also specific tax deductions that can be made that would not be possible for a 'passive' investment such as providing mortgage financing. ☗





Dalia Barsoum , MBA , FICB and Enza Venuto, AMP, CMP and are lending advisers with CENTUM Streetwise Mortgages #11789 and real estate investors with over 48 years of combined lending , financial and investment experience. The team provides advisory services and lending solutions tailored to Real Estate investors and different investment strategies.

Jillian Brett is President of Solutions Property Network Inc. a Real Estate Investment company specializing in Rent-to-Own opportunities in Ontario.