Errors to Avoid When Refinancing A Rental Property

I've learned a few things recently as a result of becoming an unintentional landlord. After trying to sell my previous home for well over a year without success, I turned it into a rental property. Because I was never planning to hold on to this property, I made a judgment call that in retrospect, has turned out to be an error. I needed to pull most of the equity out of this smaller home (it was nearly paid off) to put 20% down on my fancy new attending home.

Since I was planning on getting rid of it within a few months, I opted for the least expensive option to get the equity out. That turned out to be a home equity loan (HEL). It was at a lower rate than the previous mortgage, and had minimal fees (~$200), so it seemed the best option for a bridge loan. (A bridge loan is a real estate loan to cover the time period between when you buy a house and when you sell your old one.) In retrospect, now that it is a rental property, I wish I'd done something else that is no longer available to me. Here are the lessons I've learned in the process.

Your Cash Flow Is Better With A Longer Loan Term

This one is a bit of a no-brainer, but for me, has turned a property that would have had a positive cash flow into one with negative cash flow. Home equity loans are generally for a term of no longer than 20 years. 20 year mortgage payments are obviously higher than 30 year mortgage payments. That higher payment, combined with the other expenses, pushes me into a negative cash flow situation. Not nearly as negative as carrying an empty property for over a year, but still, it would be nice to not have to feed the beast each month. A good chunk of that payment is going into my pocket as equity,

of course, but it is still money I can’t spend or invest elsewhere.

You Can’t Refinance A Home Without Taking It Off The Market

One of the reasons I chose the HEL as my bridge loan is that a true mortgage refinance would have required me to take the home off the market. Nobody would refinance a home that was for sale. Perhaps they were afraid I’d take the cash and then mail them the keys, I don’t know.

HELs Are A Lot Easier To Get Than A Mortgage

The HEL didn’t require much of an appraisal, which was an added benefit. They basically just asked me how much it was worth, then offered a maximum loan to value ratio of 80%, which was exactly what I wanted. It took one phone call, some mailed paperwork, and a fax. Less than 2 weeks total.

You Get A Lot Better Rate On A HEL If It Is The Only Loan On The Property

If your HEL is secondary to another mortgage, you’re not going to get a good rate. If the HEL replaces the mortgage, your rate may be up to 2% lower.

Refinance Before You Move Out

If you think you’re going to convert your residence into an investment property, refinance it before you move out. Rates are significantly higher for non-owner occupied properties than for your principal residence. How much higher? About 0.5% if you have a loan-to-value (LTV) ratio of 75%. That goes up to 1% for an LTV ratio of 80%. And above 80%? Forget it. You can’t even get PMI these days for an investment property.

So, in retrospect, what I should have done was a no-cost, money-out refinance before I put it on the market. Now

instead of a 30 year loan at 3.75-4.25%, I have a 20 year loan at 5.35%. Not the worst thing in the world, but it's an error that will cost me ~$1500 a year for the foreseeable future and makes my investment cash flow negative. Now my options are to just deal with it, or to aggressively pay the loan down to a 75% LTV ratio and then refinance, which might, if I'm lucky, get me down to 4.5-4.75%. You live and learn I suppose.