[Guest Post] The Accidental Landlord: How to Decide to Sell or Rent Your Old Home

Today's post is a guest submission from Zolo, Canada's largest real estate brokerage firm. An "accidental landlord" doesn't buy a property with the intention of turning it into a rental, but rather falls into that situation after deciding to do so down the road. The GYFG household has been an "accidental landlord," and although it turned out okay when we sold our property ten years after we purchased it, we were very happy to ultimately dispose of it.

Yet, although we were glad to sell, that doesn't mean we would not be open to "landlording" again one day in the future; in fact, we have plans to eventually upgrade at least one more time, with the renting out of our current residence in that scenario definitely a topic of discussion (although this is at least six years from now). The post below is perfect if you find yourself in such a situation.

One final note, please realize that this is for illustration purposes only, and it may not capture all variables. Make sure you do the math yourself if you find yourself contemplating becoming an accidental landlord.

Teaser: If you're looking to move and you have the cash, equity and credit, renting out your current home can be much more lucrative than selling.

You bought your first house or condo a few years ago, but now you're ready to move into something nicer. What do you do?

Most people sell their current property and use the equity as a down payment on the new one. But if you have a lot of equity and a good income, you have another option: Keep both properties and rent the old one.

After all, you know the property and neighborhood better than anyone. If it's a good place and you can earn more in rent than you pay in expenses, why turn down the extra income?

The idea isn’t perfect for everyone, and there are a few things to think through to see if renting your old home is right for you. Below is an outline of the financial options and numbers you’ll need to consider.

Total housing debt

There are three main components to qualifying for a mortgage on a second house. The first is your debt-to-income ratio. Lending standards dictate that investment property buyers have no more than 45 percent of their monthly income tied up in debt payments (including property taxes and home insurance). This is only slightly higher than the 36 percent for standard borrowers. Experienced landlords can count their rents as monthly income, but would-be first-timers cannot, with certain exceptions.

So say you bought a $140,000 property seven years ago with 20 percent down and a 3.9 percent interest rate, making your monthly mortgage payment $530. Assuming an additional 30 percent for taxes and insurance, your total payment would be about $690. But now you want to buy a $200,000 home. If you put 20 percent down on the new house and lock in at today’s rate of 4.5 percent, your monthly mortgage payment would be $811. Taxes and insurance would take the total to $1,055.

To qualify for both of those loans, assuming you have no other debt, you’d have to earn at least $47,000 a year.

Down payment

The second component to getting a mortgage is a down payment. Generally, 20 percent of the value of the home is required.

If you don’t have that much money sitting in the bank, you can unlock the equity in your first home to use as a downpayment on the second. There are three main ways to do that:

- A home equity loan, which is like a second mortgage on your house. You’re borrowing against the equity you’ve built up — but not all of it. You generally can’t get a home equity loan that will take you below 15 percent equity in the home.
- A home equity line of credit, which is a revolving line of credit that allows you

to borrow against 80 to 90 percent of the home's value, in some cases, but it is generally for smaller amounts than a loan and comes with a variable interest rate.
- A cash-out refinance. Here, you simply refinance your original mortgage and borrow up to 80 percent of the value of the home, cashing out any equity you have in excess of that.

In our example, say that $140,000 house you bought has appreciated by 2 percent each year and is now worth $160,000. Also, you've been putting an extra $50 a month toward the mortgage. In that case, you'd now only owe $91,000 and have $69,000 of equity. You generally can't borrow against the first 20 percent of the home's value, but that still leaves $37,000 in equity you can tap. If you kick in another $3,000 from savings, you'll have that 20 percent down payment for your new place.

To unlock the maximum amount of equity from your home, it's important to find a good appraiser who can give you an accurate value of the property.

Financial reserves

The final component of financing is the Fannie Mae requirement that you have in reserve 2 percent of the total amount borrowed on your two properties. In our example, that's 2 percent of $290,000, which is $5,800.

Return on investment

Just because you can get the financing you need to keep your old home doesn't mean you should. You've got to determine whether the return on that investment (ROI) is good enough.

The "investment" part of the ROI equation is easy. It's the amount you owe on the house — in our example, $130,000. The return part is the amount you get in rent minus the amount you spend in unavoidable costs — taxes, home insurance and maintenance.

The "return" is your rent minus expenses (not including the mortgage principal and interest). In our example, if you could rent the original property for $1,500 a month, you'd collect $18,000 for the year. Annual taxes and insurance are about 30 percent of the loan payment, so about $2,400. Annual maintenance costs are about

1 percent of the home's value, so $1,600. You also have to factor in vacancies, which average close to 8 percent nationwide, so about one month's rent. Tally it up and you're left with $12,500 at the end of the year, an ROI of nearly 10 percent.

But what if you could only rent your house for $1,000 a month? You'd only collect $12,000 a year in rents and have the same $5,500 in expenses, netting you only $6,500 on the same $130,000 of investment. That's an ROI of only 5 percent. Is that good enough?

Net Income

The answer to that question is layered, but a litmus test is whether you can collect enough rent so that it adds to your net income. To figure that out, we simply include the mortgage principal and interest payment in your expense list.

In the $1,500 monthly rent example, you're clearing $12,500 annually, or about $1,040 a month. Let's assume you kept your original mortgage, which you locked in seven years ago at 3.9 percent, and then took out a home equity loan for $29,000 fixed at 7 percent for 30 years. The monthly loan costs will be $725. That means you have an extra $315 coming in each month that you can use to pay down the loan or sock away in case your repair estimates prove optimistic. You could also hire a property manager, which generally costs about 10 percent of the rent collected, so about $150 a month in this example.

In the $1,000 monthly rent example, you're only clearing $6,500 annually, about $540 a month. Your loans still cost $725 a month. That means your cash flow would actually go down $185 every month. If you hire a property manager at $100 a month, it will go down $285 each month. That's a recipe for disaster.

Is it worth it?

So if you have the income to qualify for two mortgages, have the equity and savings to make the down payment, have the financial reserves and can charge the rent you need to improve your cash flow. Is it worth the hassle? In 10 years, will you look back with regret or satisfaction?

Let's look first at what would happen if you simply sell your first home and plow the money into your second one.

In that case, you owed $91,000 on a $160,000 property. If you sold, you'd capture

the entire $69,000 in equity, which you can put toward your new $200,000 house. Assuming a 4.5 percent interest rate today and a stable housing market rising at 2 percent per year, your new home would be worth about $245,000 in 10 years, and you would owe $105,000. That would add $140,000 to your net worth.

But what if you kept that first property?

For your new house, you'd only have put $40,000 down instead of $69,000. So after 10 years, it would still be worth $245,000, but you'd owe $128,000. We must also account for the $3,000 you used from savings to make the down payment. If you had left that in a stock market index fund that averages a 10 percent return each year, that $3,000 would have turned into $8,000. Subtracting that $8,000 leaves you with an improved net worth of only $109,000.

But for your first property, if you used the $315 in additional net income each month to pay down the loans (first the home equity loan at 7 percent interest, then the original mortgage at 3.9 percent), you'd completely pay off the $37,000 home equity loan and pay the original mortgage down to $45,000. Assuming a 2 percent annual rise in the property's value, it would be worth $195,000 in 10 years. That's a $150,000 boost to your net worth.

Taken together, you'd be $140,000 better off selling the first property to buy the second, but you'd be $259,000 better off keeping the first property and using its equity to finance the second.

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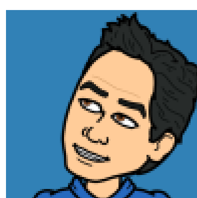
Zolo.ca is Canada's largest private real estate brokerage. Zolo.ca is a full service real estate, brokerage and mortgage company that has real estate agents throughout Canada. Zolo.ca's online real estate marketplace has over 8 million Canadian homes and up-to-date MLS listings.



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More