How Does A Rent To Own Work?

The rent to own strategy is just like how it sounds, a tenant rents a property with the intention (and option) to buy the property at some point in the future (and at a pre-determined price).

To help the tenant prepare for the purchase, a rental rate over and above the market rate is included in their monthly rent which helps to build up a rent credit (this credit goes towards the purchase of the home). The total monthly rent (the market rent + the rent credit) is often similar to what the mortgage payment would be if the renter had bought the property already (and obtained financing through a bank).

For example, if a single family home (3 beds, 2 baths, 2 storeys, good neighbourhood) rents for approx. $1,300 per month as a standard rental unit, in a rent to own (RTO), the tenant may pay $1,700 per month and $400 of that $1,700 goes towards the purchase of the property (when and if they buy).

Thus, if the renter (known as a Tenant-Buyer) elects to purchase the property after 1 year, they will have $4,800 ($400 times 12 months) towards the purchase of the property. This, coupled with an Option Fee (similar to a down payment but usually only approx. 2-5% of the Purchase Price) which the Tenant-Buyer (TB) pays to the Landlord at the beginning of the rental period, goes towards the purchase price.

Here’s An Example:

Purchase Price for Tenant-Buyer:	$350,000
Option Fee from the TB:	$10,000
Monthly Rental Credits from the TB:	$4,800
Net Cost to TB when they Purchase:	$335,200

In essence, the TB no longer has to come up with $350,000 when they buy the property, they now have to come up with only $335,200 (plus standard closing costs). And, if the Tenant-Buyer is able to obtain good financing, they may only need to put down a few more thousand to make-up the difference between the purchase price and the mortgage amount. This effectively helps the Tenant-Buyer to get into a home and start building equity right away (it's like forced savings) instead of having to put aside $500, $600, $700 per month into a (low interest) savings account.

Why Would a Renter Do This?

So, why would a renter choose to do this option rather than just saving and buying later or even buying now? Several reasons:

1 - They may not have a large enough down payment today to qualify for the mortgage

2 - Their credit may be damaged and so they need some time to correct it to ensure they can get the best rates and terms available (why pay 10% interest with bad credit today when you can build up down payment credits in a RTO, improve your credit and obtain 5% interest tomorrow?)

3 - They want to get into the home ownership market today because they think houses will be too expensive for them a year or two from now but again, they may not quite have the down payment, credit, or even income to obtain ideal financing today

4 - They may want to "test" being a homeowner. Perhaps the renter has never bought their own home and doesn't know how much work/costs/time being a homeowner can consume versus being a renter. The RTO strategy gives them a feel for being a homeowner, without having to come up with a ton of cash (for the down payment and closing costs) to buy today.

Who Makes A Good Rent to Own Candidate?

Beat-up or No Credit – If a prospective tenant-buyer has been turned down by a bank because of credit problems, a rent to own may work for them. However, it is important for the tenant-buyer to have a plan to get their credit in better shape during their rental term (so that they will qualify for financing when they purchase the home).

New to Canada – Another good rent to own candidate is a tenant-buyer who is new to Canada. Often when new immigrants come to Canada qualifying for a mortgage can be challenging. A RTO allows the new Canadian to get a foot-in-the-door of a property earlier than would otherwise be possible.

Recently Self-Employed – Buyers who have been self-employed for less than 2 years will find it difficult to qualify for a mortgage at a conventional bank. Since most lenders require a minimum 2 year history on your self-employment income, an RTO can give the self-employed buyer a chance to get their business going while still working towards homeownership.

Good Employment / Income History – A tenant-buyer or rent to own candidate should be able to prove they can pay their monthly rent to the seller on a consistent basis. Because their credit may not be strong (or established), the RTO candidate should be able to show or verify to the Seller that their income can support the monthly payments. And, the tenant-buyer should only pay up to 40% of their gross income in monthly rent payments. If the rent adds up to more than 40% of their gross (before tax) income, then the prospective property is likely too expensive for the tenant-buyer and they should find something more affordable.

What If The Tenant-Buyer Cannot Buy the Home?

The tenant-buyer may lose their deposit credits if they are unable to qualify for a mortgage at the end of the term (unless the term of the Lease and Option is extended).

A tenant-buyer should always speak with an experienced mortgage broker or banker before starting a rent to own to ensure they have a realistic and achievable plan in place to re-establish their credit during the term of the contract.

Are There Any Risks for the Seller?

The biggest risk is the tenant-buyer does not buy the home at the end of the term (either because they cannot qualify or they choose not to buy). If this happens the seller would have to attempt to sell the home again or do another rent to own with a new tenant-buyer.

A further risk is generally the price is agreed upon at the start of the term, and if the property appreciates at a much greater rate than anticipated (or agreed upon at the start of the contract), the seller will lose out on the equity gain (and appreciation). The tenant-buyer however will obtain this “extra” equity when they purchase the home.