15 CLEVER WAYS TO COME UP WITH A DOWN PAYMENT FOR A RENTAL PROPERTY

SparkRental

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INTRODUCTION

For most real estate investors, coming up with the next down payment for a rental property is the greatest barrier to buying. Nowhere is the adage "It takes money to make money" more obvious than in real estate investing!

In fact, when we've polled in our Landlords & Real Estate Investors' Hub on Facebook, the most common challenge to buying new properties is always "pulling together the next down payment for an investment property."

We hear you loud and clear. So we've put together an exhaustive guide on exactly how you can beg, borrow, save, and otherwise assemble the down payment required for your next rental property.

HOW MUCH DO I NEED FOR A DOWN PAYMENT ON A RENTAL PROPERTY?

Like most questions worth asking, the answer to this one is "It depends." Specifically, it depends on the type of financing you're borrowing, it depends on your credit history, and it depends on how risky you look to lenders.

But that's not much of an answer, so here's a better one: between 15-30% of the purchase price of your next investment property (unless you house hack – more on that shortly). Where your down payment will fall in that range depends on what kind of loan you use to buy your next investment property.

CONVENTIONAL MORTGAGES

On the lower end of the down payment spectrum lie conventional mortgages, requiring a minimum of 15% down (often more). But conventional mortgages come with far more rules than portfolio loans or commercial loans. Expect high credit, income, and cash reserve requirements among conventional lenders. And they take longer to close, typically 30-60 days.

Also remember that you will need to pay for mortgage insurance if you take out a conventional mortgage with less than 20% down.

As a final note on conventional lenders, bear in mind they typically impose strict rules on the source of your down payment. They want it to come from your own savings, in cash, and they typically require that cash to be "seasoned," meaning in your bank account for at least two months prior to closing.

That means they won't let you use many of the options on the list below, because normally they don't allow any part of the down payment to be borrowed from someone else.

PORTFOLIO LOANS

The alternative to conventional mortgages is portfolio loans. A portfolio loan is a loan kept in-house by the lender, rather than bundled and sold to a large mortgage servicing company. Examples include local community banks, and online investment property lenders like LendingOne and Visio.

These loans typically require at least 20% down, settle within 14-30 days, and tend to be more collateral-oriented in their underwriting. In other words, they carefully scrutinize your deal and the property itself, to make sure they agree that it's a good deal, but have fewer requirements regarding your income.

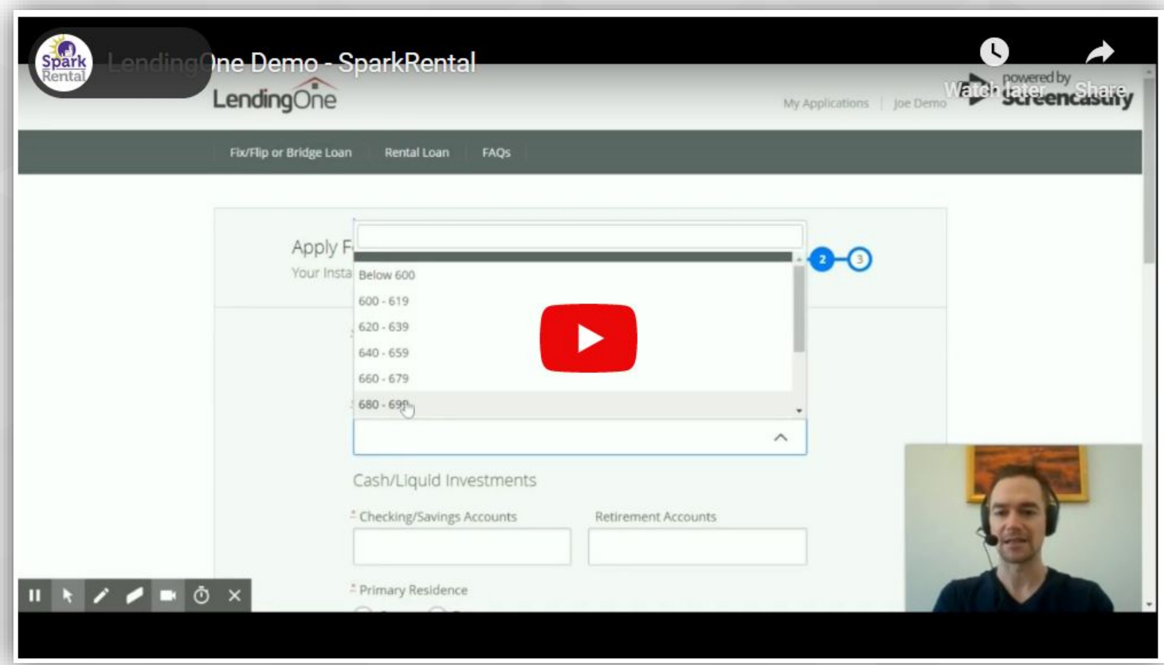
In many cases (such as with LendingOne and Visio), they don't require income documentation at all!

One other perk is that many portfolio lenders don't impose seasoning requirements, and don't ban you from borrowing the down payment. Their attitude is more laissez-faire toward the down payment for investment property loans, more akin to "We're not paying it, so you're on your own to pull it together."

The downside for this greater flexibility? Portfolio lenders tend to charge slightly higher interest rates and up-front fees.

While these are the two main sources of loans for rental properties, they're not the only ones. Here are some more rental property financing ideas to consider, before settling on a lender.

Portfolio lenders tend to be relatively fast and easy to work with, as they require far less documentation than conventional mortgage lenders. Here's a quick demonstration of me submitting a loan application to LendingOne in under a minute:



CASH RESERVES, CLOSING COSTS, & MORE

Regardless of whether you borrow from a conventional lender or a portfolio lender, you will need cash reserves.

Lenders require that you have enough cash set aside at settlement to cover a certain number of months' mortgage payments. The typical range is one-to-six months' worth of payments.

Where it gets hairy is that often lenders require cash reserves for *all* of your mortgages – not just the new loan you're borrowing.

And, of course, you'll need cash to pay for the closing costs. That includes between $1,000-2,000 for title-related expenses, taxes, insurance, and lender fees, which will lay on thousands more dollars. No one said borrowing a mortgage was cheap!

The upshot is that you need a lot more cash than just a down payment. Keep in mind these other cash requirements, as you start running the numbers on how much you'll need to pull together to buy this next investment property.

15 Ways to Come Up with a Down Payment for an Investment Property

Not scared away yet? Good, because despite the high cash requirements for buying investment properties, you have plenty of options to come up with the cash for a down payment on a rental property. You may even be able to buy your next rental property with no money down!

Before we dive in, it's worth pausing to note that the best source of funds for a down payment was, is, and always will be cash from your savings. When you borrow a down payment from someone else, you leave yourself vulnerable to overleverage, to slimmer cash flow margins and returns, and to possible rate hikes or called loans.

This is why we're so big on boosting your savings rate and cutting your spending, and even going so far as living on half your income. The more of your own savings and cash you can invest with, the better position you're in to earn high returns from your rental properties.

All right, I'm finished proselytizing, let's dive into some alternative ideas for coming up the down payment for an investment property!

1. HELOC on Your Residence

Have some equity in your home?

One of the most effective ways to borrow money for a down payment on an investment property is to take out a home equity line of credit (HELOC) against your primary residence. It's relatively affordable, it's flexible, and if you have a lot of equity, you can borrow a lot of money!

HELOCs can be fixed-interest or variable, based on the prime rate. They typically have a 10-15 year draw period, during which borrowers can use the line of credit like a secured credit card. During this time, the borrower often only pays interest on the credit balance, and does not have to pay any money toward principal each month.

After that, there's a 15-20 year repayment period, when the borrower can no longer pull money from the line of credit, and must make regular monthly payments to pay off the balance.

Many real estate investors use a HELOC to cover the initial down payment or the renovation costs when they buy a new property. After renovating, they then refinance to pull some cash back out and pay off their HELOC balance, and then go out and do it all over again.

Alternatively, you can use a HELOC to fix and flip a house, rather than keeping it as a rental.

As a final note, keep in mind that conventional lenders won't like you using HELOCs to come up with the down payment for an investment property. First, they don't want to see any part of the down payment borrowed, and second, it will add more debt to your debt-to-income ratio (DTI).

It may also lower your credit temporarily, like any other new debt.

You can compare quotes for HELOCs over at [LendingTree].

2. RENTAL EQUITY LINE OF CREDIT ("RELOC")

All right, so "RELOC" may not be a term, but it's still a thing. Landlords can take out lines of credit against their rental properties, rather than against their homes, if they have sufficient equity.

As with mortgages, expect the interest rates and fees to be higher on credit lines against an investment property compared to a HELOC. That's because the risk to lenders is higher, as borrowers are more likely to default on investment property loans than on their home loans.

You can also expect the maximum LTV (loan to value ratio) to be lower, with RELOCs compared to HELOCs. That means that lenders will lend you less of the property's total value, again because their risk is higher.

Like HELOCs, rental property lines of credit make for flexible sources of financing for new investment properties… if you have the equity.

You can also use [LendingTree] to compare quotes for rental property lines of credit.

3. CROSS-COLLATERALIZATION

Another option if you have equity in your home or other rental properties is cross-collateralization.

Wait, cross-collata-what?

You can offer to let your lender put a lien against your home or another rental property, as additional collateral. Say you apply for a loan to buy a new rental property, and they require a 20% down payment (plus closing costs, plus cash reserves). You don't have enough cash, but let's say you do have another property with $100,000 in equity in it.

So, you tell the lender about your equity, and they agree to use that other property as additional collateral, and waive your down payment requirement. They now have two properties secured for one loan, and feel confident that even if you default, they can recover their money by foreclosing on both of your properties.

4. YOUR 401(K)

Thinking about raiding your nest egg? It gets tricky quickly when you borrow money from your retirement accounts to buy investment properties, beware!

But here are the basics. First, if you know – with 100% certainty – that you will be able to pay the money back in under 60 days, you can withdraw the money from your 401(k). As long as you return it within 60 days, it doesn't count as a distribution, and you don't suffer the IRS's wrath with penalties and back taxes owed and lots of tears.

Since that's a risky play, you have another option: you can borrow the money from your 401(k) administrator. Sure, it's technically your own money that you're borrowing against, but until you reach 59 ½, you don't have access without the aforementioned penalties. But the good news is that 401(k) loans are very cheap, since you're basically borrowing money from your future self. Money that, incidentally, is already in your account.

You can borrow up to around $50,000, or up to around 50% of your 401(k) balance, whichever is lower.

5. YOUR ROTH IRA

Like 401(k)s, you can pull money out of an IRA for up to 60 days penalty-free, as long as you put it back promptly. Which is just as risky with IRAs as it is with 401(k)s.

Another option with IRAs is to use a self-directed IRA to buy investment properties. With that said, it requires you to set up a self-directed IRA with a custodian, which involves some work.

Alternatively, you can pull contributions back out of your Roth IRA any time, penalty-free. But not earnings – any gains in your Roth IRA must stay put until you're 59 ½, or you'll face IRS penalties.

One final option is to pull money out of your account to buy a primary residence for house hacking (more on that coming). The rules are different in Roth IRAs when you pull money out to buy a home:

1. It must be your first home,
2. Your Roth IRA must have been open for at least five years,
3. The funds must be used directly toward the home purchase, and
4. You can't withdraw more than $10,000.

Read up on more details for using retirement accounts to buy investment properties before trying it at home!

6. HOUSE HACK TO SLASH YOUR DOWN PAYMENT (AND LIVE FOR FREE)

House hacking involves buying a home to live in, and finding a way to have someone else pay money put toward your mortgage.

There are plenty of approaches to house hacking, from buying a small multifamily and renting out the other units, to renting out bedrooms in a single-family, to living there for a year before moving out and converting it into a rental. Deni found an even more ingenious way to house hack, by bringing in a foreign exchange student!

(Here's a quick case study on how one young man with no real estate experience house hacked a duplex and now lives for free.)

What does all this have to do with down payments? Simple: the down payment requirements for primary residences are far lower than for investment properties.

For example, instead of paying 15-30% in a down payment, most FHA borrowers pay 3.5%. And yes, they can still buy a two-, three-, or four-unit property.

Even conventional mortgage giants Fannie Mae and Freddie Mac now offer loan programs with as little as 3% down. Far, far less than you would need to come with for a minimum down payment on an investment property.

And, of course, you get someone else's rent to help you cover your mortgage payment. Definitely a win-win!

If you want more tips on house hacking and other ways to cut your expenses, Deni and I chat about ways to accelerate your savings for a down payment on an investment property here:

7. SELLER FINANCING

Why not ask the seller to lend you the down payment?

Seller-held second mortgages are common, although expect the loan term to be significantly shorter than for traditional mortgages. No seller wants to hold a loan for 30 years; they want their money sooner rather than later.

But as with everything else in real estate investing, seller-held seconds are negotiable. That goes for everything from the loan term to the interest rate to any up-front fees. Perhaps you offer to pay higher interest for a longer repayment term, or negotiate a 30-year amortization period with a three-year balloon.

In fact, if you're planning on refinancing or selling the property within the next few years, a balloon payment can be an excellent compromise between you and the seller. In a balloon note, the remaining balance of the loan becomes due by a certain day; in the example above, your monthly payments are based on a 30-year amortization schedule, but you must pay the entire balance of the loan within three years, through either refinancing or selling the property. That way, your monthly payments remain low, but the seller still gets their loan repaid in its entirety within a few years.

8. LOANS FROM FRIENDS & FAMILY

Like so many other options on this list, you can't borrow money for a down payment if you're using a conventional loan. But if you're borrowing a portfolio loan, lenders usually allows it.

Your parents, siblings, aunts, uncles, friends, grandparents are all viable sources to borrow from, to help you accumulate the down payment for your next investment property.

And they're not likely to rake you over the coals on interest or fees, either. As with seller financing, all terms are negotiable.

One other perk: the debt won't appear on your credit report, and the lender may not include it when calculating your DTI (if they bother calculating it at all, which many portfolio lenders don't).

Just make sure you confirm that the portfolio lender you're using allows it, before begging your family and friends for a loan!

9. CO-INVESTMENT FROM FRIENDS & FAMILY

A loan isn't the only option, when raising money from friends and family. They might want in on the action, as a partner.

If your friends and family balk at the idea of a loan, ask if they want to go in on an investment property with you. You'll have to negotiate terms: who's providing how much of the down payment for the rental property, who's overseeing contractors and renovations (if any), who's managing the property and tenants.

Most of all, agree on an exit strategy. Will one partner buy the other one out at a certain point? For how much? Or will you eventually sell the property on the market to cash out? When?

The only wrong exit strategy is not having one, and leaving the partnership open-ended. Because inevitably the day comes when one partner wants to cash out, and the other wants to keep holding the property.

10. SELL YOUR OLD STUFF

I just did this myself, and raised around $700. Not enough to cover a down payment of course, but a good start toward one.

Of course, parting with your old belongings is more difficult than it sounds. My wife Katie pushed me to sell my kegerator, and the whole time I was thinking "But what if I want to brew beer again one day?"

(Can you tell I'm still a little sad about it?)

But the truth is that it's liberating to get rid of the physical "stuff" cluttering up your home and life. Brad Pitt said it well in Fight Club: "The things you own end up owning you."

The trick is maintaining the discipline not to go buy more stuff to replace the stuff you got rid of. Breaking the cycle of consumerism is a good first step, if you want to live on half your income and put more money toward investments and early retirement!

11. CREDIT CARDS

All right, so pulling cash from credit cards is among the riskier tactics on this list. But it's still an option.

The advantages to drawing on credit cards for your down payment include speed (it's instantaneous) and flexibility (you can repay it as quickly or slowly as you like). The enormous, hulking, elephant-in-the-room disadvantage? It's expensive.

Your credit card company will likely charge you three or four "points," or percent up front in the form of a cash advance fee. Then there's the interest, which typically falls in the 16-24% range.

That's a lot.

Also keep in mind that it's not a viable option if you're borrowing a conventional mortgage, since it involves borrowing money to cover the down payment. Plus it will affect your credit score and DTI.

Still, if you only need the money for a couple months, and know for a fact that you'll receive an influx of cash shortly afterward, credit cards can be a fast, flexible source for funding a down payment on an investment property.

Here's some further reading on how to use credit cards to buy real estate. I've done it myself, and it worked out pretty well, actually.

12. PAY OFF YOUR CREDIT CARD DEBT

Swinging in the opposite direction, you can pay off your credit card debt to free up more of your monthly income for savings and investments.

As mentioned above, credit card debt is expensive. Too expensive – if you have credit card debt, it should be your first priority, as you're not likely to earn a higher return on your investments than what you're paying in interest to credit card companies.

If you have credit card debt, pay that off before investing in real estate or stocks or anything else. Once you've gotten that monkey off your back, you can start funneling money aggressively into saving a minimum down payment for an investment property.

13. WHOLESALING PROPERTIES TO OTHER INVESTORS

Familiar with the business model of wholesaling real estate?

The premise is simple: you find good deals, then pass them along to other investors – for a margin. For example, you find a property worth $75,000 as-is (and let's say $150,000 after renovations), that the owner is willing to sell for $50,000. You put it under contract for $50,000, and turn around and sell the contract to another investor for $60,000.

You get a $10,000 margin without ever having to take title the property, the seller gets the quick sale that they want for $50,000, and your buyer gets a $75,000 property for $60,000. It's a win for everyone.

But wholesaling requires two critical skill sets: finding excellent off-market deals, and building a buyer's list of real estate investors to step in and take over the contracts. Far too many novice real estate investors think of wholesaling as an easy way to get started, because it doesn't require much capital. Wholesaling is labor-intensive however. It's a *lot* of work to find these deals good enough to wholesale for a decent margin, and to build a reliable buyer's list. The good news? These skills cross over to actual real estate investing quite well, and will serve you once you start investing for yourself.

Check out of our review of Propstream's real estate investing tools, which make it much easier to find off-market deals.

14. FIX & FLIP A HOUSE

Another way to raise capital for the down payment needed for a rental property is by flipping a house or two before buying a long-term rental.

"But wait a second! It still takes a down payment to buy a property to flip!"

It does. But not necessarily as much of one; you might flip cheaper properties, to accrue the down payment for a higher-end rental property. And some fix-and-flip lenders (like LendingOne) cover 90% of purchase price if the property appraises well, leaving you with a smaller down payment for a flip.

Of course, you'll also need the money to begin repairs. Even though lenders like LendingOne and Patch of Land cover 100% of your renovation costs, you still need to put the money up initially for each draw, before being reimbursed by the lender (based on the draw schedule).

Hard money loans are also a useful tool for flips. Read up on the pros, cons, and uses of hard money loans here.

15. REFINANCE AFTER RENOVATING: BRRRR

The BRRRR method is an acronym for buy, renovate, rent, refinance, rinse and repeat. (Okay so there's a fifth R in there somewhere. Whatever.)

When you refinance after renovating a property, you can pull your initial cash back out, to use as the down payment for your next rental property. In this manner, you only really need to save up the first down payment, because you can keep using the same cash over and over to buy new properties.

Except with each property you add to your portfolio, you also add to your monthly income. That helps you snowball your income to put more and more money into each successive deal, helping you expand into larger, more lucrative investment properties.

You can use lenders like LendingOne, Patch of Land, or a hard money lender for the initial purchase and renovation, and then refinance for a long-term mortgage with LendingOne, Visio, or some other long-term rental lender.

I initially built my rental portfolio this way. It's a classic strategy for a reason!

FINAL WORD

Real estate investors have plenty of options for raising the minimum down payment required for an investment property.

And while I encourage you to be creative, I also caution you not to overextend yourself. Leverage is an incredible benefit to real estate investing, but it comes with its own risks.

Early in my career I bought too many rental properties, too fast. By the time I realized what I'd done, I'd already multiplied my mistake by buying ten properties, all leveraged to the hilt, and with negative cash flow.

This is why we spend so much time focusing on how to calculate a rental property's cash flow, and breaking down visuals of how real estate cash flow works. It's also why we went out of our way to create a free rental property cash flow calculator, to help you forecast returns, cash flow, and expenses.

Feel free to utilize and combine the tactics above as needed to raise your next down payment for a rental property. Just be careful to run your cash flow numbers beforehand, and to make sure you're not biting off more than you can afford to chew.

How have you raised capital for a down payment on an investment property? What are your favorite tactics?

Connect with us on social!

About the Author

G. Brian Davis is a landlord, real estate investor, and co-founder of SparkRental. His mission: to help 5,000 people reach financial independence by replacing their 9-5 jobs with rental income. If you want to be one of them, join Brian, Deni, and guest Scott Hoefler for a free masterclass on how Scott ditched his day job in under five years.