CHAPTER 1

Investing in Rental Real Estate

Becoming a landlord is about as easy as buying property. It doesn't matter the type. The thing that matters is what you do with it. And that's what this book is about: buying real estate with the intention of doing something with it—specifically, using a property to generate a cash flow in such a way that you and the people who are making the cash flow—your tenants—benefit.

This chapter introduces the basic idea of owning property as an investment. Whether you're new to the business or a seasoned investor looking for some fresh tips, this chapter will help you understand what property ownership and landlording is all about. It lays out the basic concepts that make property investment an attractive option relative to the other kinds of investments that exist, and tells you what differentiates real estate from other kinds of investments. We also discuss the basic options for property management, a facet of real estate investing that eludes most would-be real estate investors until they have to do it, as well as the disposition of properties when it comes time to sell—an act that has significant implications for the value you hope to realize from your real estate investment.

INVESTING IN PROPERTY

Some of Canada's wealthiest families, those in the business establishment as well as newcomers, rank among the country's successful real estate investors. Small holdings that have been well-managed and developed the equity required for continued property investments were the ticket to wealth for these property barons whose names are both known and less-well known: One thinks of the Belkin and Lalji families in British Columbia, the Reichmans and Bronfmans of Ontario and Quebec, not to mention the Dobbin family in Atlantic Canada. Smaller families have also done well, with some streetscapes in cities across Canada dominated by families whose business interests have flourished thanks to savvy investing in key areas.

The residential property sector alone currently accounts for close to one million residential rental units, according to the Canadian Federation of Apartment Associations *(www.cfaa-fcapi.org)*, an umbrella group representing 17 rental industry organizations across Canada. All told, the business of supplying rental accommodation to Canadians represents $37 billion annually.

The benefits of real estate aren't unique to those who make a business of investing in property. Statistics from the Canadian Real Estate Association show that property values have increased an average of 5% annually over the past 30 years, helping boost the wealth of just about anyone capable of buying a home. Moreover, recent research from the University of British Columbia suggests that real estate ownership is the key element in boosting an individual's wealth. While a quarter of what renters put away gets lost through taxation, a homeowner's principal residence stands to appreciate in value over the long term—and the gain in value is tax-free. A renter seeking to accumulate as much wealth as the standard homeowner would have to invest every spare penny in instruments returning 9% annually in order to match the financial success of a homeowner.

Tallying the Advantages

Whatever the long-term financial advantages of owning real estate are, there are also a number of sound reasons why it makes sense to view real estate, alongside fixed-income investments (savings accounts, term deposits, and bonds) and equities (stocks) as part of a sound and diversified investment strategy.

Low risk

All investments are subject to a degree of risk, and people do lose money in real estate. Becoming aware of the pitfalls and tapping into some sound advice will certainly boost your chances of success and improve the chances real estate will hand you a decent return when you're ready to sell whatever properties you've acquired. One of the big factors real estate has in its favour, and which helps to make it one of the soundest forms of investment, is that there's not a whole lot more of it being created—at least at ground level (highrise condos are another story). By familiarizing yourself with the factors affecting the market where you hope to invest, you will be able to maximize the success of your property.

Leverage

Leverage is the practice of using a small amount of capital to access a loan or some other means of financing that allows you to buy more than you could with your own money. A highly leveraged purchase requires you to take on a large amount of debt, and significant risk, but it could also deliver a huge reward if you manage the debt wisely. A highly leveraged real estate purchase typically provides the purchased property as security for the loan, reducing the risk to the lender but—if you're able to manage the debt—allows the purchaser to build the equity that is required to purchase more property. If the lender has to sell, the net proceeds after sale should at least cover the amount of the mortgage, as long as the value of the property is increasing. Since less expensive properties are typically eligible for smaller mortgages, a period of deteriorating property values will put the investor and lender at risk if a property is too highly leveraged.

Here's how leverage works: A 10% down-payment on a property worth $200,000 is $20,000. To purchase the property, you would have to borrow 90% of the purchase price, or $180,000. Should the price of the property increase by 10% in the course of the first year—a scenario that's not unusual in many markets—the return on your investment would be just under 100%. That's because you have not only the money spent to purchase the property—the down payment and whatever payments you've made over the course of the year—you also enjoy the gain in the property value of $20,000. All for the low cost of your original down payment and a few mortgage payments.

Appreciation

The property you buy stands to increase in value over time regardless of what you do. Certain geographic areas or locations may see property values rise faster than other areas, and some may enjoy slower growth or even a decline, but a well-selected, -located, and -maintained property stands to increase in value.

Equity

When you pay off the financing you obtained to buy a property, you're making its value your own. Though the true equity is what the eventual sale of the property will net you, the point remains that real estate gives you a chance to see equity increase over the course of the investment rather than putting it all in up front for a fixed return. Paying off that debt provides a structured savings plan. And then there's the opportunity for an appreciation in the value of your property while you're making those payments, adding to the equity you can expect to realize.

Shelter from inflation

Real estate can serve as a hedge against inflation by increasing in value at a rate that's typically three to five percentage points above the inflation rate. That means if inflation—which varies from month to month—is running at 3%, your real estate investment will probably be appreciating at 6% to 8%.

It's also worth noting that since you're paying off your mortgage in dollars that reflect inflation, your purchasing power is likely increasing as you pay off a mortgage that was arranged in yesterday's dollars. All going well, that means your ability to pay your mortgage is likely to increase as the debt becomes smaller. Other investments, such as term deposits, are less flexible insofar as the equity you put in will never appreciate faster than inflation, and the interest they pay will be closer to the current inflation rate than appreciation of real estate is. The Bank of Canada provides information regarding current inflation rates, as well as calculators to determine the impact of inflation on an investment, on its website: *www.bankofcanada.ca.*

Tax advantages

There are numerous types of tax advantages to buying real estate, whether you have bought your own home or purchased an investment property. For example, interest income from bank accounts, term deposits, and similar investments are fully taxable as income. So, if a deposit is earning you interest of 6% and the inflation rate is 3%, the effective return you're getting is 2%. And, if you're paying tax at a rate of 35%, the interest you've earned has been wiped out by taxes and inflation before you've even enjoyed it! Since gains in the value of your primary residence are exempt from taxes, real estate is an attractive place to put your oney. Other advantages to investing in real estate include

- reduced tax rate of 50% of capital gain from investment in real estate;
- ability to write off a portion of business expenses against rental income;
- ability to use losses from rental properties to offset other sources of income;
- deduction of real estate property investment expenses against income;
- write-off of depreciation of the building against income.

Income potential

A property purchased for rental purposes could ensure a monthly income stream to you, providing expenses and debt servicing costs don't outweigh the rental income. You'll not only enjoy having some extra cash on hand, but being able to demonstrate positive cash flow will automatically increase the value of the real estate, often substantially.

Part-time involvement

Real estate may not be as passive an investment as a term deposit or stock holdings, but a well-managed property will not require you to spend any more time than you're willing to devote to it. A good rule of thumb is to make sure the property is within a comfortable drive of your primary residence, just in case it requires your attention.

BUYING PROPERTIES TO RENT

The long-term rise in property values may boost the wealth of the average homeowner, but many real estate investors are hands-on owners who want to see the properties they're investing in generating cash on an ongoing basis. Making sure that happens requires a different set of skills, and a different set of criteria than the homeowner-to-be applies to buying a home.

Sizing Up a Home, Sizing Up an Investment

A homeowner is primarily concerned with his or her own comfort with the property, and the amenities the surrounding neighbourhood offers. Typical areas of interest include

- transportation links, such as access to good public transit or quick links to local arteries and highways;
- amenities, including a diversity of local shops, schools, parks, and community centres;
- property attributes, such as the size of the lot.

A future landlord, however, also takes into account the potential for appreciation of the asset in its given setting, as well as the current ability for the asset to generate revenue. The property has to be worth buying in itself and because others think it's going to be a great place to rent. A property in a trendy neighbourhood that requires fixing up may be a good buy because it's available for a relatively cheap price in an area that's seeing high rents. On the other hand, a great property where no one wants to be is a poor investment unless you know the area's fortunes will improve (and can stick it out until it does).

Questions to ask before buying an investment property include

- Is the kind of property you're buying in short supply in the area? Why or why not?
- What are demographic trends like for the area you're looking at? Are people moving in or out, and why?
- What have land values been doing in the areas where you're looking?
- What are observers, both inside and outside the real estate industry, saying about the prospects of the area where you want to make an investment?

Sizing Up Your Goals

The interest you have in buying the property should, to some degree, mesh with your long-term plans and goals. Buying an investment property simply because you want some real estate just doesn't make sense unless you realize what you're getting into both as an investor and as the manager of an operating business—that is, as a landlord. The market where you've bought may offer the best prospects for resale down the road, but if your interest in overseeing the property fades after the first few months, you're going to regret the investment way before you enjoy the rewards.

A good place to start if you want to figure out if landlording is for you is with a suite in your own home. Not only can a tenant be a "mortgage helper" who helps you own your own home faster, the joys and headaches of having even a temporary tenant will give you a good idea of whether or not becoming a landlord full-time is something you want to pursue. Points to keep in mind as you consider becoming a landlord include tenants, cash flow, investment time frames, and market cycles.

Tenants

Cultivating a good tenant-landlord relationship may seem like an obvious factor in becoming a successful landlord. It means even the best tenants will require attention from you, however. Tenants tend to notice the maintenance you might otherwise ignore on your own home, while keeping track of and collecting rent is an integral part of a landlord's life—and livelihood. A rental agreement is an important management tool, but you also have to be ready to live by it—enforcing it if necessary.

Cash flow

The quality of the property you're offering as a landlord should help you secure the kind of rents you're looking for. A maintenance schedule that allows you to make modest, ongoing investments to the property will help support the cash flow you're counting on from month to month, and from tenant to tenant.

The long haul

The greatest advantages to any real estate investment typically come over the long term, typically between 5 and 12 years. Some observers feel market cycles are actually lengthening, which means you may have to hold and manage a property even longer in order to realize a return. Being able to patiently maintain an investment for the required length of time, and successfully operate it, is a key element of being a landlord. It requires sound planning, realistic goals, and determination.

Downturns

Various kinds of economic storms can affect the real estate investor who is also a landlord. Not only can the real estate market enter a period where people are slow to buy or values even decline, tenants may be difficult to find for some properties. Being prepared for either scenario requires a broader skill-set more than patience. You may find yourself needing to sell the property for less than you expect, or holding a property that's generating less income than you originally budgeted. Or you may have to learn new skills and strategies to address both situations.

The good news is, soft markets provide opportunities to improve your property when there's less incentive to do so. That way, you're ready to take advantage of the opportunities to sell when the market improves. Market cycles are discussed in Chapter 2.

LEARNING THE BASICS

Compared to other investments, real estate ranks as a relatively easy investment. All you need to do to capitalize on a rising market is pull together the cash and financing required to buy a property. If you've already bought a home, an investment property may even seem like a no-brainer.

Operating real estate is another matter and brings with it plenty of opportunities to learn—not just about the property, but about relations, legal scenarios, and local regulations. It pays to examine your background before you invest and identify the skills you bring to your role as a landlord. Are you familiar with the risks you face, or will they be new challenges for you? Identifying your weaknesses can open doors to learning and developing new skills that will minimize the risks you face as a property investor. Recognizing when you need assistance—and getting that assistance—is key to being a successful investor.

The good news is that many of the skills you'll need to acquire are easily acquired, either through formal seminars or courses, or books like this one. In addition, there are a number of organizations that may be able to provide training and support as you become familiar with being a property investor and landlord.

Courses and Seminars

Many colleges and apartment owners' associations offer basic courses in property management. These may be part of formal educational programs leading to degrees or part of continuing education offerings. Either way, investigate what your local post-secondary institution has to offer, and ground yourself in the basics.

Alternatively, you may wish to sign up for seminars and workshops hosted by industry groups and private consultants. True, some of the seminars will be in the vein of get-rich-quick schemes, so a reference to, or research on, the credibility and usefulness of the programs will help you choose which opportunities will be best for you. Provincial apartment owners' associations as well as the national Canadian Federation of Apartment Associations (*www.cfaa-fcapi.org*) may be able to recommend seminars that they or others co-ordinate, while the National Real Estate Institute Inc. regularly offers sessions delivered by leading experts in the investment real estate field. Refer to *www.homebuyer.ca*. The interests of commercial property owners are served by groups such as the National Association of Industrial and Office Properties as well as the Building Owners and Managers Association (both of which have regional chapters across Canada).

Helpful Organizations

A number of organizations are available to assist investment and rental property owners across Canada, both in the residential and commercial sectors. Many of the groups offer both support and educational services, and several also advocate on behalf of member-owners.

Residential property organizations

The Canadian Federation of Apartment Associations (*www.cfaa-fcapi.org*) is an Ottawa-based umbrella group that represents 17 residential property owners' associations across Canada. For a list of member websites, refer to the "Helpful Websites" section at the back of this book.

In addition, the Canada Mortgage and Housing Corp. (CHMC) is an important source of information, both regarding the residential market as well as trends in housing. CMHC also administers programs that may assist you in improving or renovating your property so that it can better serve the needs of tenants.

Non-residential organizations

There's no one umbrella group for non-residential rental properties, which is both an advantage and disadvantage for the investor seeking to become involved in this market. On the one hand, information isn't channelled through a single clearing house where you can find out everything you need to know. The advantage of the sector's complexity and diversity is that you have a greater chance of finding a group that matches the property you're working with.

Two of the major groups, however, include the National Association of Industrial and Office Properties (NAIOP) and the Building Owners and Managers Association (BOMA). Both have regional chapters across Canada.

NAIOP focuses on commercial and industrial properties, as its name indicates. Development issues are a major concern for the association, but its members also have a lively interest in management and operation of properties as income-producing properties.

BOMA focuses exclusively on the ownership and management of buildings and is notable for initiatives aimed at increasing the efficiency with which buildings operate such as its environment-friendly Go Green program that has led to the refurbishment of commercial properties across the country in recent years.

GETTING A GRASP ON MANAGEMENT

A good property manager doesn't just make the decisions that create value in a property. A host of other, secondary activities go into creating value, from selecting tenants and managing vacancies, to maximizing revenues and minimizing expenses. Being able to identify and balance the various factors that contribute to the success of a rental property is an integral part of a manager's job. The question is, is management for you?

Being a landlord doesn't have to entail first-person management, of course. Depending on the size of your portfolio, you may wish to hire a professional manager rather than handle all the management duties yourself. And, while you as property owner are ultimately responsible for ensuring a manager does a good job of operating the property and maintaining it in a decent condition, a manager can make your life easier by taking care of business you would rather not have to address.

Assessing Your Aptitude

A quick assessment of your willingness to manage a property might lie in your responses to the following scenarios. How would you respond if you had to deal with one or several of the following (either individually or simultaneously)?

- late-paying tenants
- disruptive tenants
- high vacancies
- high turnover
- vandalism
- sporadic cash flow
- disputes with tenants
- regular complaints, real or frivolous
- never-ending maintenance

Chances are, if you answered "Not well" to any one of the above situations, you might wish to delegate the management of your investment property to a property manager. After all, you shouldn't have to be constantly stressed out about what's happening on and to your property. Also, if you buy a well-run property expecting a certain cash flow, you don't want to find yourself slipping into a situation where headaches are constant, cash flow declining, and your investment isn't the deal you thought you were buying.

Matching Skills with Properties

If you are keen to take on the management of your own property, what kind of property should it be? And at what point does it make sense, regardless of your abilities, to contract out management?

Typically, small revenue properties with fewer than eight units can benefit from an owner's direct involvement in management. In addition, single-family homes and duplexes are typically under the supervision of the owner, who selects the tenants and handles maintenance and many of the other chores required for his or her own home. More complex properties require the attention of a dedicated manager, however, as they are more complicated than a single-family dwelling both from a structural point of view as well as the number of relationships that exist.

In addition, even if you manage a property yourself, you may wish to contract out regular chores such as landscaping, snow removal, and the like. You can easily contract out these services, especially if you have a handful of properties.

Self-management, regardless of your capabilities, may be necessary if you live outside a major metropolitan area. A professional manager isn't always available in smaller communities. Even if there are people willing to manage your property, you may choose not to give them the job for any number of reasons. The positive side is that a revenue property in a community where there's a shortage of suitable managers is probably small enough that you can handle it yourself.

We discuss management at length in Part III.

CAPITALIZING ON GAINS

A successful real estate investment will be that much more successful if, at the end of your career as an investor, you can translate the equity you've built up into a retirement income for yourself or a legacy for others. That makes it important to find a place for real estate in your long-term financial plan.

Planning for Success

Financial plans are not just about your future goals, but how you get there and what you do once the goals are achieved. They help identify what you need to do to reach your goals, and help you know how to deal with setbacks. Drafting a financial plan involves five basic steps:

- selecting your professional advisors;
- assessing your current and future financial situation;
- establishing your goals and priorities;
- developing a financial plan;
- evaluating your progress.

An objective plan, prepared with the assistance of professional advisors, equips you to develop a real estate portfolio that serves your needs. The plan should address aspects of your investments including your insurance coverage, investments, debts, tax situation, retirement strategy, and estate plans.

Trading On Success

While a well-managed real estate portfolio can provide ongoing revenue that you can use for any number of purposes—including reinvesting it in the property or other investment vehicles—the big payoff usually comes when you sell a property and recoup the equity it has developed as you've paid off the mortgage or its value has increased. Many investors invest with a view to funding their retirement, so devising a disposition strategy that helps achieve your financial goals will be integral to the financial plan you develop for your retirement.

Other investors may sell an investment property due to a change in strategy or a belief that it's time to trade up into other, more attractive assets with better growth potential. You might consider the strategy of pyramiding, for example, by which you purchase select assets on a regular basis and sell others, ensuring that your portfolio constantly renews itself and doesn't become stale.

Enjoying Your Success

Selling a property in order to trade up is one option for an exit strategy. You may also want to sell your entire portfolio, cashing out in order to enjoy a well-deserved retirement.

Converting your real estate portfolio to an annuity of some sort in order to fund your retirement is one option open to you, but you may also wish to set up a living trust that places your portfolio in the hands of an independent manager, usually a trust company, with family members as co-trustees. The trust receives your investment portfolio and the trustees manage it such that you receive a stable income for life, similar to an annuity. The remaining capital is distributed to family members on your death. The provisions of the trust agreement should provide instructions for the financing of your care should you require long-term medical attention.

Appointing family members as trustees could be an option, especially if they have an interest in real estate investments. Trust companies will charge fees to administer your portfolio, but they provide a wide range of professional services. The key attributes to seek in a trustee are independence, impartiality, and fairness. Having said that, there could be benefits to using the services of a trust company, depending on the unique circumstances of your situation. Some benefits of using a trust company are

- Accessibility
- Full attention to the needs of your estate
- Providing portfolio management
- Ensuring control when that role is important
- Confidential nature of the estate administration business
- Sharing responsibility
- Financial responsibility and security
- Funding capacity
- Specialized knowledge
- Acting as a trustee
- Group decisions
- Avoiding the possibility of family conflict
- Peace of mind

An important safeguard on your success, especially as you grow older, is a well-crafted will that takes into account your investment activities. Dying without a will not only leaves your family grieving your loss but also stands to deprive them of any benefit of the hard work you've put into your investment portfolio.

If you die without a will—a condition known as being intestate, or without a testament to your intentions—the government will distribute your estate for you as set out in provincial legislation. Suffice it to say your heirs will thank you if you draw up a will. If you don't have a will, it will not leave a legacy of fond memories due to the negative implications.

It is essential that you have a will prepared by a lawyer who specializes in will and estate law. In many cases, this is done in conjunction with strategic customized feedback from your tax professional.

The lawyer you choose as your legal advisor for real estate should be one who specializes in real estate law. You need different legal skills for different purposes. We discuss selecting legal advisors in Chapter 4.

For more information on wills and estate planning, refer to *www.estateplanning.ca* and the book by Douglas Gray, *The Canadian Guide to Will and Estate Planning.*