CHAPTER 1

Understanding Real Estate Investment

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Many Canadians have made a fortune in residential real estate and have become financially independent in the process. Many, even when financial markets plummeted on the back of U.S. housing woes in late 2008, didn't see the same sort of losses on real estate that their stock portfolios did. By following a prudent investment strategy, you can mitigate the risks of investing in real estate and come out a winner—even during a downturn. Since real estate is often a long-term investment, you have time to pursue a methodical approach that lets you do the necessary research and acquire the background knowledge that lets you feel comfortable with the decisions you're making. This book provides that knowledge, enabling you to make informed decisions that minimize the risks and maximize the profits possible from your real estate investment.

According to a recent survey by the wealth management division of Merrill Lynch and private consulting firm Capgemini, there are approximately 282,000 millionaires in Canada. But this number accounts for investable assets only—not those with cash in real estate assets. Add those whose total net worth, including real estate, is more than $1 million, and the number of millionaires would be far greater. Many ordinary Canadians have profited simply through long-term home ownership and regular contributions to their Registered Retirement Savings Plans (RRSPs), both of which yield tax-free gains.

There are distinct advantages to starting your real estate investment by purchasing a principal residence. A starter home—whether it's a studio apartment or an older, 750-square-foot bungalow in need of some TLC—gives you a foothold in the market and a chance to start building equity. Data from the Canadian Real Estate Association shows that between 1981 and 2010, sale prices for homes increased an average of 1 per cent a month nationally. Of course, not all months or geographic areas were equally favoured, but it is indicative of the long-term trend. Another Canadian study showed that residential real estate appreciates with an average margin of 4 to 5 per cent over the rate of inflation. Still, a third Canadian study demonstrated that the average return on residential real estate investment exceeded other forms of investment.

The key conclusion is that making money in real estate is not an impossible dream, one only for professional tycoons, but a realistic possibility for the average Joe. Sure, as with any investment, there are risks and pitfalls. But by learning some basic principles and applying the strategies outlined in this book, you can make a profit, build your personal wealth, and even ease your way into an early retirement. The tips in this book will also save you money in many different ways.

The preface gives you an overview of what to expect from this book. Although each chapter is self-contained, they should all be read thoroughly as the concepts, tips, strategies, and pitfalls are frequently interconnected in terms of the overall real estate investment environment. Look through the detailed table of contents, including the appendix material, to get an idea of what to expect.

This first chapter is an important foundation chapter to assist you in understanding the framework in which you will be operating. Whether you are buying your first home or other residential revenue property, you can't operate in a vacuum in terms of the market. Knowing how the market works will develop self-confidence, street smarts, and improve your chances of making the right choices. This chapter covers why you should consider investing in real estate, understanding the real estate market, establishing your investment strategies, buying with others, and avoiding the pitfalls.

Why Consider Investing in Real Estate?

Before investing in real estate, it's worth considering the advantages and disadvantages. There are many advantages to a sound real estate investment. There are also risks that can make an otherwise sound investment a disadvantageous prospect, and personal factors may work against your investment plans, too. Nevertheless, here are some of the reasons why you should consider investing in real estate. (The disadvantages are outlined on page 7.)

Advantages of Real Estate Investment

Here are the main advantages that make real estate investment attractive, compared to other types of investments. Many are interrelated and work together for the success of your investment.

- Low risk. Any investment has a potential risk, and you can indeed lose money in real estate (the reasons why are covered in this book to help you avoid them); however, real estate has traditionally been a secure, stable investment compared to other investments. Buying prudently

and with a knowledgeable strategy helps reduce the risks you face as an investor. The strategies for mitigating risk vary depending on macroeconomic factors, the geographic area, and stability of the local market, among other considerations. Some of the things to take into account include population changes and density, the amount of land available for development, the proportion of renters in a given area (it's usually higher in cities, which works in your favour), and the ease of financing in terms of availability and competition. Supporting these factors (and lowering your risk) is the intrinsic need and demand people have for a place to live and the consistent appreciation of land values over and above the inflation rate as land is developed to meet that need. The market is cyclic and, depending on location and so on, property values tend to eventually increase.

- Part-time involvement. Real estate investments require close attention, but they don't need to be a sinkhole for your time. Once you learn the techniques, you will be more efficient, selective, and confident in how you manage your investments. Many investors have been able to start with a single property or even a partial investment with others, and build a portfolio of properties while running their own businesses. The real estate is merely a place to invest savings. Determining how much time you are prepared to spend researching the market, negotiating, buying, managing, and selling properties at the outset will help you determine how deeply involved you want to be.

  Moreover, the skills required to be a successful investor can be learned—again, without taking up all your time. Naturally, if you are buying real estate for investment other than your principal residence, more knowledge and skills must be acquired. The essential knowledge is covered in this book.

- Low starting capital. Real estate allows you to take a minimum amount of money, sometimes as little as $10,000 to $20,000, and borrow the rest using the property itself as security—an infrequent strategy with most other kinds of investments. You might start off with a $150,000 condominium, for example, putting 10 per cent down, and obtain a mortgage for the remaining 90 per cent. This is considered high-ratio financing (a conventional mortgage requires a 20 per cent down payment; further details are discussed in Chapter 5, "Understanding the Financing Aspects"), but the payoff to you can be just as great—with a wise strategy—as if you borrowed a smaller amount.

  The key is leverage. Take the example of the $150,000 condominium. You borrowed 90 per cent ($135,000) and put in 10 per cent of

your own money ($15,000). Perhaps the property's value increased by 10 per cent over the course of a year. What would be the return on your original investment of $15,000? The answer is 100 per cent. In other words, the increase in value of your home of $15,000 (10 per cent appreciation of the $150,000 original price) is a 100 per cent return on your down payment of $15,000. Conversely, if you had put all your own money into the home—that is, $150,000—your return would have been merely 10 per cent.

By the same token, the condominium is a highly leveraged investment; nine times as much money was borrowed as invested. But the risk to the lender is low or non-existent, as the property is the security. If the lender has to sell, the net proceeds from the sale should cover the amount of the mortgage, given real estate's ability to maintain its value and even appreciate. And if the market enters a downturn, the requirement for high-ratio mortgages to carry insurance (provided in Canada primarily by the Canada Mortgage and Housing Corp. [www.cmhc.ca], Genworth Financial Canada [www.genworth.ca], and Canada Guaranty Mortgage Insurance [www.canadaguaranty.ca]) would cover your payments to the lender.

A concept related to the idea of leverage is pyramiding. This strategy involves borrowing on the increasing equity in your existing properties, applying the principal of leverage, to acquire additional properties over time. Done prudently, this strategy compounds the increase of equity in your portfolio and the potential accrual of considerable wealth.

- Appreciation. This simply means the increase in value of the property over time. It is the growth in value of your original capital investment. The national average has been approximately 10 per cent annually over the past 30 years. As a caution, it should be stressed that it is an average. Certain geographic areas or locations can have less than that, and some considerably less. Conversely, a well-selected, located, and maintained property in a growing community could be higher than the average. If the real estate cycle is going up in a high-demand area, the appreciation could increase as much as 25 to 50 per cent in one year. A basic axiom in real estate is that what goes up rapidly and in a sustained fashion tends to come down—sometimes rather suddenly.
- Equity buildup. When you make payments on your mortgage, you are paying down on the principal over time. As you reduce your debt, you

are at the same time building up your equity—that is, the portion of your original house price on which you no longer owe any money. This is independent of the percentage increase in appreciation or value of the property. In practical usage, most people commonly refer to equity as the amount of clear value in the property that the investor owns, free and clear of any debt. It is the amount of equity that a lender will lend further money on and place a mortgage on as security. In realistic terms, your true equity is what you would net upon sale, after all real estate commissions and closing costs are taken into account. Lenders realize this as well, which is why they generally do not like to lend on 100 per cent of the equity in order to minimize risk and leave a margin for safety.

- Inflation hedge. You are probably well aware of the concept of inflation, a phenomenon that sees the cost of products and services increase over time and your own purchasing power decrease. Something that cost $5 three years ago might be priced at $10 today. People on fixed incomes that are not indexed to inflation are keenly aware of the loss of purchasing power that inflation inflicts. The inflation rate in Canada has been stable at about 2 per cent in recent years, but it varies seasonally and regionally. Canada experienced double-digit inflation in the 1980s, but current policies—set by the Bank of Canada (www.bankofcanada.ca)—aim to keep inflation as close as possible to 2 per cent.

  The appreciation of the value of property over time naturally accounts for inflation. Historically, land appreciation value for residential homes has been 4 to 5 per cent greater than the inflation rate. A benefit for real estate investors is that financing is repaid in inflated dollars. That is, you are probably getting more money now in terms of salary increases (and rental revenue) to repay a loan that's worth less in today's dollars than when you took out the original mortgage.

- Tax advantages. There are numerous types of tax advantages to investing in real estate, whether you have a principal residence or investment income property. For example, all the interest you receive from a savings account (even a tax-free savings account, or TFSA), term deposit, or a guaranteed investment certificate (GIC) is eroded by inflation. Savings that earn you 3 per cent when the inflation rate is 3 per cent will earn you an effective, or real, rate of return of 0 per cent. Deposits outside a TFSA that are subject to taxes push your return into negative territory. Real estate does not have this problem, so wisely investing in real estate—starting with a principal residence—is attractive.

Other tax advantages of real estate investing are discussed in Chapter 7, "Understanding the Tax Aspects." It's fair to say that few investments have as many benefits as real estate, some of which include:

- tax-free capital gain (on your principal residence);
- the ability to write off principal residence suite rental income against your home expenses;
- the ability to write off a portion of a home-based business income against your home expenses (the home-based business could even be to manage your residential investment income);
- lifetime personal capital gains exemption of $750,000;
- reduced tax rate of 75 per cent of capital gain from investment in real estate;
- flow through of losses from negative cash flow against other sources of income;
- deduction of real estate property investment expenses against income; and
- the ability to write off depreciation of the building against income.

- Income potential. A prudent real estate investment could result in a net positive cash flow income to you every month—that is, after all expenses and debt servicing have been taken into account. The income not only provides additional money, but the fact that you have a positive cash flow is a factor that automatically increases the value of your income-producing real estate. This is discussed in greater detail in Chapter 3, "Finding and Evaluating the Right Property."
- Attractive return on investment. For all the reasons outlined in earlier points, clearly the potential for an attractive return on your investment—not only before tax but after tax—is very high in real estate. Keep in mind that it is not what you make before tax, but what you can keep after tax that is the important investment criteria.
- Increasing demand for land. Land is a finite commodity. Due to the population increase and decreasing supply, real estate prices go up. Many communities have slow growth or no growth policies, due to rapidly expanding needs for community services. This restricts land availability for new development, causing existing land to go up in value. Real estate is a commodity that the public needs. Other

investment commodities are not so reliable because they don't constitute a public need and therefore demand. In addition, many people want to have a second home, as a retreat, vacation property, or for retirement. This creates further demand on land.

Disadvantages of Real Estate Investment

To provide some balance, there are some limitations to investing in real estate that may not be present in other forms of investment. But by being aware of these limitations, you are going into the investment realistically in terms of expectations and planning. Most of the limitations can be dealt with or eliminated satisfactorily. Here is a brief outline:

- Subjective feelings. This problem is particularly common when people buy their first home. Some people make decisions based on emotion, rather than sound preparation, knowledge, and objective assessment. Developing a sound investment strategy should help mitigate the role of emotions, while honing your knowledge to ensure you can trust your gut feelings when it comes to investment decisions.
- Lack of liquidity. A liquid investment doesn't always mean a bottle of wine or fine single-malt Scotch; rather, it refers to the ease with which you can realize its cash value via a sale. Several factors affect liquidity, but one of the most common is demand. The least liquid assets are often found in the least desirable locations. On the other hand, an asset that hasn't attracted demand might be your ticket into a market that's about to become one of the country's star investment areas (but always do your homework).
- Extended holding period. Many real estate investments are held for 5 to 10 years, or longer. This is often a wise strategy that helps avoid the cyclical nature of the market. You will have to wait, however, to see a return on your investment. You may wish to consider alternative investments if your investment time frame is short.
- Time expenditure. The investment could take a considerable amount of your time, but with advance planning, this should not happen unexpectedly. If it does, you have other options, as explained in Chapter 10, "Managing Your Property."
- Potential high risk. Again, the potential for loss exists, but with prudent and cautious decision making and following the tips and strategies outlined in this book, the risk should be minimal or non-existent, in practical terms.

- Lack of accurate comparisons. Real estate, by its nature, is a market of diverse assets, conditions, and buyers. This makes a standardized reference point for comparing two or more properties difficult. While rules of thumb and other formulas exist to help gauge value (see Chapter 3, "Finding and Evaluating the Right Property"), the only true determinant of value for your particular property is its sale under a given set of conditions. The other values are proxies for its true worth, making it difficult to know what a property is actually worth until it changes hands.
- Exposure to government control. All levels of government have an impact on real estate. There are laws and regulations covering a wide range of areas, including planning, zoning, property use, building codes and licences, rent controls, and environmental regulations. Some provinces have considered introducing a special real estate speculators tax. In addition, governments can expropriate and require rights of way. All these factors could certainly have an impact on your investment. The best way to eliminate a potential problem is to avoid it to begin with. That is why you have to do your research thoroughly and obtain expert legal advice, especially in the case of income real estate investment.

Pitfalls to Avoid

It is probably timely, at this point in the book and in conjunction with a consideration of the disadvantages of real estate investment, to outline some of the classic pitfalls to avoid in buying real estate. In most cases, investors who have problems generally succumb to a combination of the following traps. By being aware of these problems at the outset, it should help you place the discussion and cautions in the rest of the book in context.

Some of the classic pitfalls that will exacerbate the disadvantages of your real estate investment and prevent you from enjoying its full advantages include not

- understanding how the real estate market works;
- understanding personal and financial needs;
- having a clear focus and a realistic real estate investment plan, with strategies and priorities;
- doing thorough market research and comparison shopping before making the purchase;

- selecting the right property considering the potential risks, money involved, and specific personal needs;
- verifying representations or assumptions beforehand;
- doing financial calculations beforehand;
- buying at a fair-market price;
- buying real estate at the right time in the market;
- buying within your debt-servicing capacity, comfort zone, and skills;
- understanding the financing game thoroughly, not comparison shopping, and not getting the best rates, terms, and right type of mortgage;
- making a decision based on an objective assessment but on an emotional one;
- determining the real reason why the vendor is selling;
- having the property inspected by a building inspector before purchasing;
- selecting an experienced real estate lawyer and obtaining advice beforehand;
- selecting an experienced professional tax accountant when selecting real estate property, and obtaining advice beforehand;
- selecting an experienced realtor with expertise in the type of real estate and geographic location you are considering;
- negotiating effectively;
- putting the appropriate conditions or "subject clauses" in the offer;
- buying for the right reasons, in other words buying for a tax shelter rather than for the inherent value, potential, and viability of the investment property;
- verifying financial information beforehand, including rental income, expenses, and property taxes;
- obtaining and reviewing all the necessary documentation appropriate for a given property before making a final decision to buy;
- selecting real estate investment partners carefully;
- having a written agreement with real estate investment partners, prepared by a lawyer;
- detailing precisely what chattels are included in the purchase price;

- seeing the property before buying it, but relying on pictures and/or the representations of others;
- managing property well, or not selecting the right property management company; or
- selling the property at the right time in the market or for the right reasons.

Understanding the Real Estate Market

You need to understand the cycles and factors that influence prices to have a better appreciation of how the real estate market operates, and how to operate prudently within it. The market is a dynamic entity, and no buying or selling decisions should be made without first assessing its conditions.

The Real Estate Cycle

Real estate is cyclical, which means there will be good and bad times, shortages of supply relative to demand (and vice versa), and fluctuations in property values: too many available properties of a given type reduce values, too few increase them. It is essential to know where you are in the economic cycle and appreciate that different provinces, regions, and communities may be at different stages of the cycle. Therefore, timing is important when making buying or selling decisions.

One of the reasons for the cycle is that many developers are entrepreneurial by nature and operate primarily by short-term planning. If financing and credit are available, developers tend to build without regard for the overall supply and demand. If a glut occurs and the demand is not there, prices drop as houses and condominiums go unsold. The phases of the real estate cycle will be discussed later in the chapter.

External economic cycles that can affect the real estate cycle include:

- General economic cycle. The economy goes through periods of growth followed by recessions. The impact is greater, of course, in certain parts of the country than in others in any given cycle. During a recession, people lose their jobs and have to sell their houses. Real estate prices drop as potential purchasers decide to wait until the economy is more secure.

  It is difficult to know for certain when the economy will turn around, but various indicators should give you some insight. (Chapter 3, “Finding and Evaluating the Right Property,” provides sources of

information about particular markets.) However, if the economy has been in a recession for a sustained period of time, there could be definite opportunities to buy. Once the economy emerges from a recession (a recovery is deemed to have occurred after two consecutive quarters of economic growth), prices tend to climb. Conversely, if the economy has been on a growth trend for an extended period of time, be very cautious about your purchase decision because a change in the cycle, and therefore a drop in real estate prices, could be imminent.

- Local economic cycle. A local economy, such as a city or province, has its own cycle and factors that have impacts on real estate prices. Some factors are related to the general cycle above; others may be related to local events such as business closures, natural disasters, and the like.
- Community economic cycle. Specific communities within a city can have their own economic cycles, as well as particular issues affecting supply and demand, all of which affect real estate prices. In addition, a community has its own life cycle from growth to decline to stagnation to recovery. When investing in real estate, it's wise to find areas of future growth and be ahead of a market upswing.

Awareness of economic, business, and community cycles is critical to prudent decision making. Before buying or selling real estate in a certain area, determine what external factors are prevalent and how they impact the cycle of the real estate market. Different types of real estate, such as condominiums, new homes, resale houses, and small apartment buildings, can be in different parts of a cycle.

A real estate cycle has four distinct stages. Each segment exhibits characteristics that are helpful in assessing market conditions and determining at what stage the real estate cycle is. (Refer to Chart 1 in the Appendix.)

The real estate market is commonly described in three ways:

- Seller's market. In a seller's market the demand, or number of buyers wanting homes, exceeds the supply, or number of homes on the market. It is characterized by homes that sell quickly, a low inventory of homes, and an increase in prices. These characteristics have implications for the buyer, who has to make decisions quickly, pay more, and frequently has his or her conditional offers rejected.
- Buyer's market. In a buyer's market, the supply of homes exceeds the demand. Characteristics of this type of market include: homes that are on the market longer, high inventory, and a reduction in prices.

The implications for buyers are: favourable negotiating leverage, more time to search for a home, and better prices.

- Balanced market. In a balanced market, supply equals demand. The characteristics of this type of market include: houses selling within a reasonable period, stabilized prices, and sellers accepting reasonable offers. The implications for the buyer are that the atmosphere is more relaxed and that there are a reasonable number of homes from which to choose.

Factors that Affect Real Estate Prices

Many factors influence real estate prices. Whether you are a buyer or seller, you need to understand what factors are having an impact on the market, so you can make the right decisions at the right time and in the right location. Many of these factors are interconnected.

- Position in real estate cycle. The position of any particular real estate market in the cycle—whether at the general, local, or community level— will have a bearing on prices. During a seller's market, prices will be high; during a buyer's market, prices will be low, and a balanced market will offer no distinct advantage to buyers or sellers in terms of pricing.
- Interest rates. There is a direct connection between interest rates and prices. High interest rates typically mean lower prices because buyers have to allocate more cash to financing their purchase than to actually buying it. When interest rates are low and financing is cheap, prices climb. The cost of financing and the price of properties will influence buyer demand and overall market health.
- Taxes. High property taxes can be a disincentive to a purchaser, contributing to a drop in real estate prices. Provincial taxes, such as a property transfer tax or speculators tax, will restrict some buyers. Changes in sales taxes, such as the harmonized sales tax (HST) in place in many provinces or the goods and services tax (GST), may influence buyers of new homes or building lots. Federal tax legislation on real estate, such as changes in capital gains taxes or the personal lifetime capital gains exemption (currently set at $750,000 for eligible property), could have a negative influence on investors. All these factors would affect the overall amount of real estate activity, including prices.
- Rent controls. Provinces have the power to establish rent controls in Canada, which limit the scale and frequency of rent increases landlords

can levy on tenants. Rent controls, and similar legislation governing landlord-tenant relations, could have a limiting effect on investor real estate activity. This could lead to fewer buyers in the market for certain types of properties. Alternatively, the removal of rent controls may provoke an investment surge.

- Economy. Confidence in the economy is important to stimulate home-buyer and investor activity. If the economy is buoyant and the mood is positive, more market activity will occur, generally resulting in price increases. Conversely, if the economy is stagnant and the mood is negative, less market activity occurs, resulting in price decreases. If real estate purchasers are concerned about the same problems, a predictable loss of confidence occurs in the market.
- Population shifts. Geographic locations with attractive business, employment, tourism, and retirement opportunities will attract people from across the country and around the world. This increased demand will increase prices. Conversely, if there is net migration out of the area due to closure or potential closure of industry, environmental problems, or other factors, real estate demand and prices will decrease.
- Vacancy levels. High vacancy levels could reduce investor confidence due to the potential risk, and real estate sales could go down. Competition for tenants increases, creating more favourable conditions for renters. On the other hand, low vacancy levels could stimulate activity among investors and first-home buyers. Renters who can't find a place to rent may borrow from relatives or find other creative ways to enable them to purchase a home.
- Location. A highly desirable location will generally see steadier and faster increases in price versus a less desirable location, or one that has fallen out of favour.
- Land availability. A natural shortage of land because of barriers including rivers, mountains and oceans, municipal zoning restrictions, and other regulations that restrict its use for housing and development will generally cause prices to increase. This occurs because the stock of developable land is limited relative to the existing and long-term demand.
- Public image. The public perception of a certain location, type of residential property, or developer of a specific building will affect demand and, in turn, price. Some areas or types of properties are hot and some are not at any given time.

- Political factors. Provincial or municipal government policy concerning real estate development will naturally have a positive or negative effect on supply and demand and therefore prices. A potential change of government, particularly in an election year, may affect market activity depending on whether market participants expect a change of government to be positive or negative for real estate sales and development.
- Seasonal factors. Certain times of year—such as winter and summer vacation times—are traditionally slow months for residential real estate sales, hence prices decline. The same seasonal factor impacts on recreational property. There are ideal seasons for purchase and sale, the most common being spring.

Establishing Your Investment Strategies

To attain the maximum financial benefit from real estate investment with a minimum of risk, you need to have clearly defined goals and objectives, and a plan for achieving them. There are four steps in the process of determining your plan.

Step 1: Self-Assessment of Skills and Attributes

Your success in real estate investment has a lot to do with the qualities that you bring to the process. It is important to know your strengths and weaknesses so that you can capitalize on your strengths and compensate for your weaknesses. This self-assessment is particularly important if you are considering group investments or owning several properties. It will help you identify your interests as well as your skills, attributes, and talents that are relevant to the business of real estate investing.

Step 2: Determine Your Current Financial Status and Needs

Start by completing Form 1, "Personal Cost-of-Living Budget (Monthly)," and Form 2, "Personal Net-Worth Statement" (see pages 333 and 336 in the Appendix). Then fill out Forms 3 and 4, in which you will calculate your gross debt-service ratio and total debt-service ratio, respectively. Forms 3 and 4 will give you some guidelines in terms of mortgage eligibility. Keep in mind that these are only guidelines. There are exceptions, and there are other creative ways of achieving your financial objectives. This is explained in more detail in Chapter 5, "Understanding the Financing Aspects."

Step 3: Determine Your Future Personal and Financial Needs

This essential step gives you an idea of the degree of risk you are prepared to take. It will also clarify your time commitment, financial involvement, and realistic short-, medium-, and long-term goals and objectives. For example, maybe you want to be financially independent, primarily through real estate investment, in 10 or 15 years.

Step 4: Plan Your Investment Strategies

Take the time to develop your investment program thoroughly. Like any plan, you will need to monitor and possibly modify it regularly due to changing circumstances. The safest way to make money in real estate is through prudent and cautious investment.

Don't look on real estate as a "get-rich-quick" scheme. There are many who have adopted that attitude, to their misfortune. Avoid the prophets of profit—that is, the self-styled gurus and pitchmen touting U.S.-oriented real estate investment programs. In many cases these real estate investment programs are not directly applicable to the Canadian context (due to differences in legal and tax matters). Some programs are barely ethical or unrealistic. Some real estate seminars and books promote the concept of becoming rich through property tax sales, foreclosure sales, quick flips of property, or the selling (assigning) of the agreement of purchase and sale before closing. In most cases in the Canadian context these options are not applicable or applicable only with considerable difficulty, risk, and skill, so considerable caution is advised.

Key Investment Strategies to Consider

Here are some the key real estate investment strategies to consider:

- Research the market thoroughly before making any decisions. Consider at least three potential investment opportunities, if possible.
- Give yourself a realistic time frame to achieve your investment objectives. For example, normal real estate cycles are 5 to 8 years and in some cases 10 to 12 years.
- Buy specific types of revenue property that are in demand and are easy to maintain and/or manage; for example, a single-family house (ideally with a basement suite for separate revenue), a condominium, duplex, triplex, or fourplex. Don't buy an apartment building until you have

experience as a landlord with several smaller properties, or unless you are going in with experienced investors.

- Attempt to make a low down payment (for example, 5 to 10 per cent) unless, of course, you can only obtain a maximum of 75 per cent financing. If you can make a purchase with a low down payment, this frees up your available cash for the purchase of additional properties. Offset a low down payment with a vendor-take-back mortgage, high-ratio financing, or a second mortgage.
- Strive to have a break-even cash flow. In other words, try to avoid debt servicing the property because of a shortfall of rental income over expenses. Make sure you cover all expenses from cash flow such as mortgage payments, taxes, property management, condominium fees, insurance, repairs and maintenance, and allowance for vacancies.
- Ensure that you have competent property management, whether you do it yourself or hire an expert.
- Rely on professionals—including a lawyer, accountant, financial planner, building inspector, appraiser, contractor, realtor, property manager—at all times for peace of mind, enhanced revenue potential, reduced risk, and realistic budgetary projections.
- Never pay more than fair market value unless there are other collateral benefits to you that you have identified. These types of potential benefits are discussed in more detail in Chapter 9, "Buying Your Property."
- Use all the tax-planning strategies available to you after receiving expert tax advice. These options are explained in Chapter 7, "Understanding the Tax Aspects."
- Keep rents at market maximums and manage expenses to keep at market minimums.
- Buy when no one else is buying and sell when everyone else is buying. This is the so-called contrarian view of investment, which is the opposite of conventional wisdom.
- Always view and inspect property before you buy. Verify all financial information. Obtain your advisers' guidance.
- Have a minimum three-month contingency reserve fund for unexpected expenses (repairs) or a reduction in cash flow (vacancies).
- Buy investment properties within a four-hour drive from where you live, so you can easily monitor your investment. There are exceptions to this general principle, of course.

- Consider applying the principle of pyramiding—that is, purchasing selected real estate on a systematic basis. For example, you may purchase one or two or more properties a year—when the cycle is in your favour, of course.

For additional guidance, refer to Checklist 6, "Master Checklist for Successful Real Estate Investing," on page 376 in the Appendix.

Buying with Partners

Investing with others is not for everyone. Most people prefer to invest on their own, if possible. Occasionally, people may choose to buy in a group. On the one hand, some people prefer to start out investing with a group as it may provide mutual support; shared (and therefore reduced) risk; pooled skills and expertise; greater investment opportunities; shared responsibility and time; and collective energy, synergy, and momentum. On the other hand, if you do not select your group investment wisely, it could be a financial and emotional nightmare. The key is to know the benefits and limitations of the various group investment options and the pitfalls to avoid. Never go into a real estate purchase with others without obtaining prior professional advice from your lawyer and accountant. Always make sure that you have a written agreement in advance.

Factors to Consider When Buying Real Estate with Others

It is important to remember that approximately 80 per cent of business partnerships don't work out. The statistical odds, therefore, are very high that any real estate group relationship in which you are involved may not survive. By cautiously assessing the individuals who will make up a potential group, you can minimize the risk immensely. Here are some key factors to consider:

Goals and Objectives

Ensure that your goals and objectives are consistent with those of the rest of the group. For example, some members may want a long-term investment (say, five years) with positive cash flow from rents; others may want a medium-term investment (perhaps three years) and be prepared to subsidize the negative cash flow in the hope that the property value will appreciate due to rezoning or subdivision potential; still others may want to flip the property within a few months of purchase because of its desirability or a because of a rapid increase in property values in a hot market.

Expertise

You know what skills you can bring to an investment partnership, and if your partners are friends and relatives, you probably have a clear idea as to what skills they bring to the table. But if you are joining an investment group of strangers or people you know only casually, it is important to clarify exactly what, if any, skills they will bring to the group investment. It may not matter, if they are silent investors—that is, if the investors are just putting their money in and are not actively involved. Sometimes these types of investors are also referred to as passive investors.

If they are active investors and it is a small group, you need to determine what skills they will contribute and in what form. If you are buying into an investment group that will be totally managed by one of the group members, make sure you know the person's credentials and track record, and get it in writing. If you are going to rely on the person to protect your investment, it would be prudent for you to be careful and cautious.

Liquidity

Basically, this means how easily and quickly you can get your money out of the investment. Your financial resources and needs will determine your liquidity needs. For example, if you need to get your investment capital back quickly, then you probably won't want a long-term investment. In addition, you should reconsider the investment if you would suffer if your money was tied up or put at risk. You should not invest money you cannot afford to lose. Therefore, be cautious about investing retirement money or contingency reserve funds if you need immediate liquidity.

In practical terms, most investments are tied up for the duration of the deal. That relates back to the investment group's goals and objectives. If you are buying shares in a real estate investment on the public stock exchange, you may have liquidity, but not necessarily at an attractive price. Also, consider having a buy-out clause in the investment group agreement. This means the group would buy you out within a fixed period, although normally at a discount price, to discourage investors from leaving the group early.

Liability

This issue is, of course, a critical one to consider. Make sure, if at all possible, that your risk is limited to the amount of your investment. You want to avoid personal liability for any financial problems that occur, either to mortgage

companies, other investors, or the investment group as such. For example, if you are investing in a corporation that is holding the property for the group and the corporation has taken out a mortgage with a lender, the lender may require personal guarantees from the shareholders of the corporation. Another example of risk would be a partnership. If you went into a general partnership with two other investors whose actions resulted in financial problems, you would still be liable for the full amount of the debt if the other two couldn't pay.

A third example of risk would be if you signed an investment group agreement and it stated that any shortfall of funds would have to be paid by the investors on a basis proportional to the percentage interest. A last example of risk would be in a limited partnership. If you stopped being an inactive partner and started to actively manage the investment, you could be liable. Also, some limited partners are asked to sign personal guarantees up to a certain limit. Avoid this scenario. You can see why you need a lawyer to look at the agreement and advise you of the implications and ways of limiting or eliminating personal liability risk.

Legal Structure

There are several types of legal structures: a general partnership, limited partnership, corporation, or joint venture agreement. Group investments fall into these categories or variations of them. Some legal structures allow more flexibility than others. The degree of personal liability exposure varies depending on the structure and the group investment agreement. Some of these were discussed in the previous point. Obtain advice from your lawyer. Also, refer to the sections on legal structures on pages 190–3 in Chapter 6, "Understanding the Legal Aspects."

Control Issues

Certain types of investment groups allow for more investor control than others. Control relates to the degree of influence that you have on the management of the investment and related decision making. Obviously, smaller groups tend to allow more individual control than others. For example, in some cases, unanimous consent is required for major decisions; in other cases, 75 per cent consent is needed; and in still other cases, a simple 51 per cent majority vote of investors will do. In some instances you do not have any vote at all. You put your money in and hope for the best. If you are buying into a limited partnership or other form of investment that is being touted to you, make sure you thoroughly

check out the promoter's previous history, experience, and reputation. You can see why management and quality of management are so important.

Tax Considerations

One of the main reasons for investing in real estate would be for the tax benefits in your given situation. Certain types of investments are more attractive than others from a tax perspective. Be very wary of salespeople or financial advisers who attempt to induce you into buying a tax shelter. That area is fraught with pitfalls and risks. You can see why you need objective and impartial advice in advance from your lawyer and professional tax accountant before making your investment decision. The property should be inherently viable from an investment viewpoint first, with tax benefits then taken into account. Refer to Chapter 7, "Understanding the Tax Aspects," for a more detailed discussion.

Compatibility

Look at the other people in your investment group. Are there similarities in personality, age, financial position, and investment objectives? What do the other group members think about issues such as control, management, and liability? What contributions, if any, are the other people making to the success of the investment? If the people in the group have diversified skills, this could save the group money and make the investment more secure. In general, people you know are safer than people you don't know. Ego, power, greed, arrogance, and unrealistic expectations are common causes of group stress or disintegration. You can't afford the risk, so be selective with your investment partners.

Risk Assessment

As discussed throughout this section, you need to look objectively at the potential risks: the nature of the investment, the potential for profit, the degree of potential personal liability, the type of legal structure, the nature and degree of control, the quality of management, and the compatibility of other investment group members.

Contribution

Find out what contribution is expected of you in terms of money, time, expertise, management, personal guarantee, and contingency backup capital. Do you feel comfortable with others' expectations of you?

Percentage of Investment

Do you feel comfortable with the percentage of investment that you are getting, relative to the contribution you noted in the above point? For example, let's say that there are four people in an investment who incorporate a holding company. One is an active partner and finds and manages the property, and the other three are silent investors. The active partner has 55 per cent of the investment, did not invest any money, and did not sign any personal guarantees. The three silent partners invested all the money equally, signed personal guarantees to the bank for the mortgage, and hold 15 per cent of the investment each. Would you feel comfortable with that investment percentage if you were a silent partner? What if you were the active partner?

Getting Out or Buying Others Out

One of the important things to consider when investing with a group is getting out. What if you want to leave for any number of reasons? Is there a procedure to follow? What penalty do you pay, how is it calculated, and how long will it take to get your money? Conversely, what if you want to buy out the other investors because of a personality conflict or some other reasons? Can you do so? If there is nothing in the agreement outlining how an investor can leave the group before the property is sold, you could have a problem.

Management

How will the group investment be managed? Will it be managed by a professional management company, a resident manager, a group of investors, one of the investors, or the original promoter? How confident do you feel about the issue of management? What are the management fees? Are they reasonable under the circumstances?

Profits and Losses

Determine how these aspects are to be dealt with. For example, what about excess revenue from the income property? Will that be kept in a contingency fund, or will a portion of it be paid to the investors? What about decisions such as selling the shares of a corporation holding the property or the property itself? How will those decisions be made and who will make them? These decisions have tax implications that will affect you. What about losses? Will the shortfall be covered by a bank loan, or by remortgaging the property, or by the group investors? In practical terms, how will that be done?

Now that some of the key factors have been discussed, you can see why you have to be careful and selective before going into a group investment.

Types of Group Investments

There are many options available in terms of group investing. The most common options are co-tenancy, general partnership, limited partnership, joint venture, syndication, and equity sharing. (See also Chapter 6, "Understanding the Legal Aspects," and Chapter 7, "Understanding the Tax Aspects.") The following discussion will explain how these types of group investments operate.

Co-tenancy

Each co-tenant has a proportional interest reflected in the title to the property filed in the land title office. For example, if three people decide to invest together on an equal basis, the title to the property would show that each party has "an undivided one-third interest each, tenants in common," or other such variation. In law, co-tenants or tenants in common can generally deal with the property without the consent of the other co-tenant(s). In addition, if a co-tenant dies, his or her interest in the title to the property goes to the estate; it does not go to the surviving co-tenants, as it does in a joint tenancy type of legal ownership.

When people buy for investment purposes or buy a property together to live in, but are not living together in a common-law or legal marriage, tenancy in common is often the way they hold the property.

The ownership of the land through tenancy in common reflects percentage ownership on title; it does not involve partnership-type obligations to third parties. To make sure that there will be no misunderstanding on the issue of partnership in case of a co-tenant dispute or creditor problems, a co-tenancy agreement should be prepared and signed. Again, make sure you have your lawyer prepare it or review it carefully if another lawyer prepares it.

Co-tenancy Cautions

In addition to the types of issues discussed in a group investment agreement, which is explained later in this chapter, consider including in an agreement that the co-tenants:

- are not partners of each other, as set out in the provincial partnership act;

- do not have the power to act for each other, except as outlined in the co-tenant agreement;
- are not agents of each other;
- can compete with each other in other real estate investments;
- are responsible for their own tax or other financial liability relating to his or her percentage interest in the property; and
- can make money from the co-tenancy without it being considered a conflict of interest; in other words, there are no fiduciary duties.

In addition, the co-tenant agreement should set out the living accommodation rights, duties, and responsibilities if the parties are living in the same dwelling. A sketch map showing the living area should be attached.

It is common for friends or relatives to invest in real estate through a co-tenant arrangement. It is also common for people who cannot afford to buy a principal residence with their own income or down payment to buy with someone else, either a parent, relative, or friend.

One of the key advantages of a co-tenancy is that it is a reasonably simple structure and relatively easy to get out of.

General Partnership

You should be very cautious about going into a general partnership. There are many potential liability risks involved, as well as investment limitations. Never go into one without competent legal and tax advice. A general partnership is governed by the partnership act of each province. The disadvantages of this type of relationship are covered on page 192 in Chapter 6, "Understanding the Legal Aspects." In brief, the risks involve individual liability for all the debts or liability of the partnership, regardless of how many other partners there are. For example, if the partnership owes $50,000 and the other two investors do not have any money or assets and you do, creditors will go after you for the full amount. Many people don't realize that, and assume that if there are three partners, the liability will be split three ways.

In addition, there are other aspects governed by the provincial partnership act. There are automatic rights that each partner has in law, tax, control, and ownership implications; non-competitive provisions; fiduciary duties (explained in an earlier point); dissolution rights; automatic breakup of the partnership on death of a partner; and inability to pledge the partnership interest as security to a lender. Lack of control and limited management and

investor options make the general partnership option an inflexible one, and the implications can be onerous for most investors. Although a partnership agreement can mitigate some of the limitations of a general partnership, it does not eliminate them. General partnerships normally only involve a few people.

Limited Partnership

This is a variation of a general partnership and a corporation. It has fewer of the legal disadvantages of a general partnership, but maintains the tax advantages. For example, the rights and liabilities of the partners are set out in the limited partnership agreement. The liability of each partner is limited to the amount of his or her investment, which is why the partner is referred to as a limited partner. The limited partner is an inactive partner, and has no control over management of the limited partnership, other than voting on the issue of who should be the manager. The general partner is normally a corporation and is responsible for the active management of the limited partnership investment. The general partner can be sued, but usually is operated by a corporation without assets.

It is important that a limited partner not be involved in any fashion with the management and decision making of the limited partnership. To do so could expose the limited partner to unlimited liability as a general partner.

The operation of a limited partnership is governed by various regulations, including a limited partnership agreement, the provincial limited partnership legislation, and possibly the provincial securities legislation. Limited partners hold their interest in the partnership in the form of "units" issued by the limited partnership. These units are similar to shares in a corporation and represent the proportionate share in the limited partnership held by the investor. Units can be sold to other group investors or outsiders, subject to the policies and restrictions set out in the limited partnership document. Many limited partnerships have a large number of investors, as the financial cost of the project can be considerable.

There can be many risks to limited partnerships. Keep in mind that the promoter is out to make a personal profit. This may or may not be consistent with making money for you from the investment. There can be many representations by the promoter (general partner) and agents of the promoter. Minimize the risk by requesting cash flow guarantees from the promoter, secured against assets of the promoter.

Attempt to get a written commitment from the promoter to purchase your unit, if you so wish, after a period of time. Make sure that long-term financing

is in place, so that you don't have to come up with more money in a short time. Finally, make sure that your lawyer and tax accountant review the project and documentation, and advise you in advance as to the legitimate tax benefits, degree of risk, and reliability of the financial and operating projections.

Corporation

You may wish to hold real estate by owning shares with others in a corporation. A corporation is usually governed by the provincial company legislation for most real estate investments, rather than a federally incorporated company. A corporation is a separate legal entity and can sue and be sued, but its liability is limited to the assets of the corporation. Individual shareholders are not personally liable for corporate liability, unless personal guarantees of the corporation were signed by the shareholders. Refer to page 192 in Chapter 6, "Understanding the Legal Aspects," for a more detailed description of corporations.

It is important to make sure that you sign a shareholders' agreement with the other investors. This agreement contains various provisions, as discussed later.

A corporation can be a convenient vehicle for real estate group investments. It is structured in such a way as to make it easy to sell or transfer shares, subject to the articles of incorporation and shareholders' agreement. If a shareholder dies, the corporation and its investment continue. The shares would go to the estate of the deceased or be purchased by the corporation, depending on the terms of the shareholders' agreement. Generally speaking, there is a limit on the number of shareholders in a corporation, beyond which the corporation could be governed by provincial securities legislation. This would involve stringent public reporting requirements and accountability, as well as limitations in the management of the corporation. For this reason, you have to be cautious and obtain legal advice to ensure that you are not covered by securities legislation. Many holding corporation investments consist of a small number of people, generally not more than 10.

Corporations are a popular means of holding revenue property such as apartment buildings. Income from the corporation is tabulated and taxed in the corporation. Investors pay taxes on income only if they receive money by means of dividends or salaries from the corporation. Otherwise, investors have to wait until the property is sold. If the shares of the company are sold to a new owner, the investor could therefore have a taxable gain on those shares. Refer to Chapter 7, "Understanding the Tax Aspects," for a further discussion.

Joint Venture

A joint venture may involve individuals or corporations who want to pool money, resources, skills, expertise, land, or other assets to make a profit by means of development or investment. Generally it is one specific project. Joint ventures can be formed in different ways, such as a co-tenancy, general partnership, limited partnership, or holding corporation, in which the shareholders are the joint venturers. It is also possible for a corporation to be formed to hold the property in trust for the joint venturers.

The nature and form of joint venture structure depends on various considerations, such as legal, tax, and financial issues, as well as the purpose of the joint venture. Most joint venture groups are small. It is essential to have a joint venture agreement drawn up and signed. Make sure that the agreement makes it clear that the relationship is not one of a general partnership, due to the tax and legal implications. Get advice from your lawyer and tax accountant before committing yourself.

Syndication

This is usually in the form of a limited partnership and is designed to provide silent investors with limited liability, capital appreciation, and tax deferral. The promoter of the syndicate or the company contracted by the syndicate undertakes management of the project. The syndicate makes money from the investors as well as from the investment itself. Generally, the cost to the investor is directly related to the degree of risk and the degree of financial and performance guarantees by the syndicate promoter. As with any investment, there is risk. Have your lawyer and tax accountant give you their unbiased professional opinions before signing any documentation or paying any money. Many syndicates have a large number of investors and are therefore governed by provincial security legislation.

Equity Sharing

There are many variations to this method of investment. In a way, it is a combination of a partnership and co-tenancy. For example, one approach is for an investor to look for a tenant who wants to buy a house but doesn't have the down payment. The investor buys the house and the tenant moves in and pays slightly more than fair market rent. The rent is sufficient to cover all mortgage debt-servicing costs, property taxes, utilities, insurance, and maintenance. Therefore, there is no negative cash flow. The tenants have a place to live and a house to maintain with pride.

The above parties sign an agreement setting out the arrangement. Generally speaking, the investor has title to the property with a stipulation that if the tenant remains for, say, three years, the tenant has the option of purchasing the house for the appraised value minus the normal real estate commission that would otherwise be paid, minus an agreed-upon percentage for the equity increase over the three-year period (perhaps 10 to 25 per cent). This could bring the house price down sufficiently that the tenant would be able to get financing and buy it. If the tenant can't or doesn't want to purchase at the end of the term, the tenant loses the option and all equity-sharing and purchase rights.

The secret of a successful equity-sharing plan is the selection of the right property at the right price and terms, the right investor-tenant match, and a well-written agreement that is fair to both parties. The agreement should be drawn up by your lawyer and cover important potential problems such as the following: the tenant stops paying, breaches other terms of the agreement, or dies; the investor declares personal bankruptcy; a disagreement occurs over the appraised value of the property; or the investor does not want to sell after three years because the market is depressed.

Equity sharing can also mean including the tenant on the title for an agreed percentage interest at the outset. This approach is not recommended as it would be difficult for the investor to get the full title back without paying considerable legal fees if a falling-out occurs with the tenant.

From an investor's viewpoint, the equity-sharing concept has some advantages as well as disadvantages. The advantages include the benefits of ideally assured positive cash flow, a committed tenant, and no management problems. From the tenant's viewpoint, the arrangement allows the tenant to choose a house of his or her own and provides a financial backer to get into the market, as well as a share of the equity buildup with an option to buy at a discounted price (net after real estate commission savings are deducted). One of the main disadvantages to an investor, though, is sharing the equity buildup. This has to be weighed against the advantages. You can do equity-sharing arrangements yourself, or invest in companies that offer the service. The problem is that you lose control in these companies, as groups of 8 to 10 investors are put together. In addition, you will have to pay the equity-sharing management company an administrative fee.

You now have a better idea of real estate group investment options. The smaller the group, the more control and involvement; the larger the group, the less control or no control, and lack of individual identity or involvement with the investment. In some large groups, investors are detached from any

involvement or input. Consult your legal and tax advisers before venturing into these waters.

Putting the Arrangement in Writing

After you have considered all the factors outlined above and decided which type of group investment you prefer, the next step is to set out a written agreement. As mentioned earlier, make sure that your lawyer prepares the agreement or reviews an agreement prepared by someone else. Each type of group investment group necessitates a different form of agreement. The agreement you sign should be customized for the specific type of investment in which you're involved, and it should take into account the factors discussed earlier.

The main points and procedures that are common to, although not necessarily all included in, group investment agreements consist of the following:

- type of legal structure;
- name and location of investment group;
- goals and objectives of group;
- duration of agreement;
- names and categories of investors (general, limited, active, silent);
- financial contribution by investors;
- procedure for obtaining additional capital;
- role of individual investors in the investment management;
- authority of any investor in the conduct of the investment group;
- nature and degree of each investor's contribution to the investment group;
- how operating expenses will be handled;
- how operating income will be handled;
- debts of investment group separate from individual investor;
- separate bank account;
- signing of cheques;
- division of profits and losses;
- books, records, and method of accounting;
- draws or salaries;
- absence and disability of investor;

- death of an investor;
- bringing in other investors;
- rights of the investors;
- withdrawal of an investor;
- buying out other investors;
- management of employees;
- sale of investor interest;
- restrictions on the transfer, assignment, or pledging of the investor's interest;
- release of debts;
- settlement of investor disputes and arbitration procedures;
- additions, alterations, or modifications to investment group agreement;
- non-competition with the investment group in the event of an investor's departure.

Summary

This chapter has provided a general introduction to the benefits of real estate investment, how the real estate market works, determining your investment strategies, avoiding the classic pitfalls, and buying with others. Now it's time to look at specific types of residential real estate.