

Chapter One



Why Invest in Real Estate?

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HAVE YOU EVER LISTENED to the song, *Times Like These*, by the Foo Fighters? It comes to mind when people ask me why I think real estate investment is a good idea. I have no trouble answering that question, but I sometimes think the people asking are a bit disappointed by my response. They want me to tell this great story about the very moment I *knew* real estate investment was for me—I want to talk about moving!

A story like the one they want to hear would likely include some pivotal moment, for example, the instant the sun hit a “For Sale” sign as I was driving down a residential street and I realized (with an overwhelming rush of emotion) that I could be buying properties and renting them out to people who needed a place to live, or fixing them up and selling them to people who needed a place to live. A story like that would evoke an epiphany of real estate awareness and would likely include some instant understanding of all of the investment principles I’ve come to hold dear—principles such as the importance of focusing on long-term wealth creation and the deliberate forging of mutually beneficial investment relationships. It would also have to include some specific ideas about how one could set up actual real estate investment *systems*, systems others could follow on their own path to success. Now that would be a story!

The reality of how I came to see real estate investment as a good strategy is less dramatic. It’s also a better story, but not because it has moments of high and low drama or because I’m so darned interesting. The real story is better precisely because I am just like most other Canadians. And that’s really important. I invest in real estate because I can make money in real estate and generate future financial security for my family, myself and my charities—and that’s it. I started investing in real estate because I could. I keep investing because I can. It has never been about what I knew

or who I knew or having a giant pot of money to start with. I had none of those advantages.

It has always been about a commitment to a long-term outlook and working hard to minimize risk while making my money work harder than I do—and I work very hard. Opportunity, like beauty, is in the eye of the beholder. Keeping that in mind, I open this discussion of the fundamentals by encouraging you to be on the lookout for two very different kinds of real estate investment advice or comment: the kind you'll get from the Armchair Authority, and the kind you'll get from those who practise the Final 30-Feet Rule.

Beware the Armchair Authority

Before we study the fundamentals that sophisticated real estate investors use to determine whether a specific real estate investment makes sense, I want to acknowledge the three primary arguments real estate investment naysayers will use to convince you that real estate investment is a bad idea. They will tell you that:

1. Interest rates will rise rapidly and anyone in real estate will go broke in an instant.
2. The real estate market is in a bubble (or approaching same, or about to break same) or a depression.
3. Nothing good ever comes from having tenants.

I am living proof that even with all of that negativity around, you can do incredibly well if you know what you are doing. (Admittedly, if you do not know what you're doing, you can create major problems.) As we don't seem to be able to escape the naysayers, I'll tell you how you can use information to counter their negative outlook.

Prophets of doom exist in all market conditions and it's impossible to steer completely clear of them. They remind me of Goldilocks, who discovers that bears have sampled three bowls of porridge, and found that one is too hot, one is too cold and one is just right. The only problem with applying this analogy to real estate naysayers is that in real estate, even when these characters find a property that is just right, they'd still tell others that it was wrong—and they should go eat eggs instead! Their reputation for having a negative outlook is more important to them than reality! Some even wear a “bear” moniker proudly—and that is why you need to be aware of the danger posed by their misinformed opinions.

I think new investors (and anyone whose portfolio is weathering a market storm or is looking for market direction when all he can see is a horizon of dark clouds) should recognize the three negative arguments listed above as warning flags. They are flags signalling arguments that should be disregarded, and they are more common now

than in past years thanks to the fact that the internet gives everyone with an opinion a chance to share it. My point is that while everyone is *exposed* to these arguments against real estate, the strategic investor arms himself with the tools to analyze what's right. When you need to make investment decisions, no one else's opinion really matters, not even mine. When confronted with negativity, my favourite response is to ask the naysayer, "What type of real estate experience do you have?" If the answer is none, or very little, you know you're listening to an Armchair Authority, not someone who knows what he or she is talking about.

Seek Out the Experienced Investor

Now consider the opposite of the Armchair Authority—the realist. I learned, very early on, to only take advice from someone who has been very successful in what I want to be successful at. You'll notice I didn't just say relatively successful, and I'm also not talking about someone who got lucky in a hot market. I want to learn from, discover insights from and hear the good and bad side of the investment world from someone who has seen it all and knows how to respond to all market conditions.

To look at how this works in the real world, consider how everyone you bump into seems to have an opinion

on the real estate market. *It's a bubble! There are too many condos! There are not enough condos! It's going to collapse! It's a great opportunity! It's better to rent than buy!* And so on. As I wrote this section I was sitting on the patio of the local Starbucks and I overheard a real estate conversation at the next table. I chuckled at the mistaken myths they were sharing—and was chagrined to realize that the speakers seemed to be making important decisions based on what I knew to be myths.

With commendable candour, one 20-something enthusiastically shared her opinions on real estate. In just five minutes she noted:

- “You won’t believe the deal I can get on a time-share! For only \$46,000 I get two weeks a year at *no charge*. That’s like a free holiday every year! The rest of the year it is rented out. Too bad it isn’t by a ski hill but the winter sun will be great, if I can get those weeks!”
- “Downtown Vancouver is not that expensive. My friend has a 380-square-foot condo and pays only \$1,400 a month rent.”
- “My friend really wants to get a place in the States because the dollar is so strong. I told him it was a great idea and that a bunch of us should pool our money and then share the profits because there is no tax as a Canadian down there.”

They say enthusiasm is a virtue, no matter how misinformed the enthusiast is. I disagree. From the gist of the conversation it was clear that no one at that table had any experience with even one real estate transaction. This young woman's declarations were so positive that her friends (even those who were significantly older than her) were accepting them as real estate gospel. She made it clear that she hadn't ever bought a property, but she had read a "ton" about the topic so she knew how it works. I was astonished to hear them respond as if their comments were written on tablets of stone.

Although certainly not lacking in confidence, this greenhorn investor lacked first-hand knowledge. Missing this critical piece to the success puzzle made her confident declarations and opinions very dangerous.

You would be right to think that a few people talking about real estate don't present an insurmountable problem for others in the business or for those planning to start. We all have to find our way in the world and that usually includes making (and then learning from) a few mistakes. But this lack of knowledge can be very dangerous when the misinformation and opinions come from people who call themselves real estate experts.

The importance of paying attention only to real authorities was first driven home for me when I heard how veteran comedian Buddy Hackett told a young and upcoming comic

how to deal with the mountains of advice that TV executives, promoters, friends and family will give her as she builds her comedy career. Buddy's advice was simple yet profound: "Listen politely, smile and allow them to feel helpful... then turn around and seek out and take advice only from those who have walked the final 30 feet."

What did he mean by the final 30 feet? When I heard the answer, I saved it and have used it ever since. To paraphrase, Hackett said:

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As a comic, only take advice from those who have walked the final and most important 30 feet from backstage to alone in front of a mic with nowhere to hide. Then, and only then, will you know the advice comes from reality and not theory. They'll understand the emotions, the work it takes to get it right. They'll have made the mistakes and created the laughs, not just read about how to do it.

These words of wisdom can be applied to virtually any decision we face in life. Hackett's point was that the world is full of inexperienced pretenders who can and will steer you wrong. Some will be confident that their opinions are correct. Others won't care. Be careful to choose advisors who

have the final 30-feet experience in real estate—and look for advisors who have chalked up decades of experience.

Now back to the conversation at Starbucks. I'm sure that young lady thought she was repeating truths; she wasn't deliberately misleading her companions. But without having bought, owned, managed or experienced a lot of real estate transactions in all market conditions, she truly lacked the final 30 feet of experience needed to advise others about the financial and emotional realities of what it's like to face tough investment decisions. Book theory, number analysis, charts and graphs are just theories and numbers if you haven't *done* what it really takes to be a successful investor. Veteran investors know there is no theory when you are in the trenches and making real-life decisions.

That is why Buddy Hackett's advice served me so well as I built my business and real estate portfolio into what it is today. By continually seeking out people who had already achieved what I wanted to achieve and who had solved the problems I wanted to solve, I could avoid the mistakes they'd made. I still let the inexperienced share their theories and opinions. But now I smile politely—and quickly move on. Apply this to your own real estate investment business by looking for people who understand what the fundamentals are all about!

The One Thing Strategic Investors Agree On: Focus on Fundamentals

How could the foundation of all real estate success be based in something as boring and dry as fundamentals? What happened to the excitement of the big cheque, purchasing a property way under value or the quick flip that added a few thousand bucks into your pocket? The good news is these do happen; in fact they happen more often when investors shift their focus away from a get-rich-quick mentality to dry, boring and extremely profitable fundamentals. Once your focus shifts, the great deals that provide long-term financial stability to your life show up much more quickly. Hidden within them are some fast, big-profit deals. In other words you get the ultimate combo deal (without all the fat, sugar and salt)!

Is this how I made my real estate fortune? Well, certainly not at the beginning! At the start I made all the bad decisions that anyone could make. While I got lucky with a few investments, I admit to chasing quick profits without even understanding the true value of real estate investment and what it could provide in terms of future financial security.

I'm pleased to say that changed. As I "looked behind the curtain" for ways to make real estate more profitable, I worked with other successful investors to develop the Authentic Canadian Real Estate (ACRE) investment system. Thanks to

that approach, it is much easier for new investors to discover that if you make real estate a bit more boring, it becomes *a lot* more profitable. That's because:

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Following the ACRE system is just like walking in the footsteps of highly successful real estate investors who aren't trying to sell you on anything other than the fact that they are doing it and it will work for you. What a breath of fresh air that is if you happen to come across a misinformed Armchair Authority!

In sum, the ACRE system gives me and other investors a proven pathway to real estate market investments through what REIN members call “fundamentals.” We do this to help new and experienced investors make real estate investment decisions based on market realities, not emotions like fear or greed. The ACRE system acknowledges that real estate investment has inherent financial risks. It teaches sophisticated investors to mitigate those financial risks by letting the underlying economics of their target region tell them whether it is a good time to buy, sell or stay on the sidelines. These investor know that real estate market numbers have very little to do with the reality of how the market performs over the long term.

Those who follow the ACRE system tend to position their portfolios 18 to 24 months ahead of the market. Because they recognize impending shifts in the market cycle, they can make bold moves before others even know that markets are changing.

First and foremost, strategic investors buy properties that fit their portfolios in terms of price and geography. While the less-educated majority buys and sells its properties because of emotional reactions to media stories (probably based on some Armchair Authority's rant about interest rates or bubbles!), the savvy investor buys and sells based on the market realities of economic fundamentals. Because she knows that the market is in constant short-term motion, she focuses on her specific area's long-term profit potential, not on monthly market peaks and valleys.

Investors who react to these short-term ups and downs leave money on the table when they let fear force them to walk away from properties that fit their portfolios or when they sell properties too early because they're worried about tomorrow instead of focusing on today. At one time I also brought an almost day-trade-like mentality to the game. It was horrible. There were sleepless nights worrying about

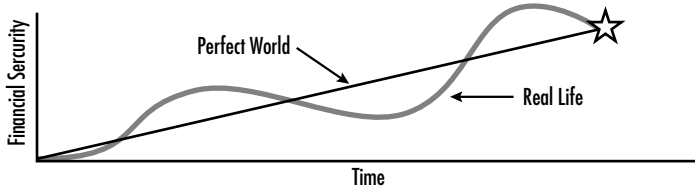
my debt load (even though it was on investment-grade real estate). I was distressed by what I had to do if a tenant left in the middle of the night (theorists had told me I should *expect* that to happen). I obsessed about whether the market was going to collapse again (because it had already done that three times before I even got into the market). Yikes!

I was an emotional wreck, because I *really* didn't know how to analyze a market, a property or a tenant. I was just following everyone else. What a mistake that turned out to be! The solution came when I started to change the people whom I was learning from, whom I started spending my time with and whose information I could take to the bank.

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The emotional investor lets fear and greed rule. He aims for perfection—and misses. The sophisticated investor keeps it real—and wins.

SUCCESS IS NOT A STRAIGHT LINE



Make Geography Part of Your System

Who would have thought so many years ago that economics and geography would be important to future financial wealth? All you hoped for was that your teacher didn't catch you napping in mid-afternoon class. I digress, but I do so with a point. Real estate investors need to understand the role of geography, but not location, location, location. While geography could be simply added to the list of top 10 fundamentals, the role of geography is so important that I always deal with it separately.

The first step to successful real estate investing is to look in a completely different direction than the mediocre majority. Your goal is to understand how to recognize regional economic strengths and then identify cities, towns or neighbourhoods within those regions that have a particularly bright future. We don't even look at the real estate numbers until after we have identified an area.

Using the ACRE system, the sophisticated investor looks for signs of future strength, not past economic success. Who cares about what's already happened? I'm investing now for what's going to happen in the future! Those who invest on past performance are chasing markets, which is a grave mistake. *Past performance is never indicative of future results.* Sophisticated investors equate that to buying a stock because its value increased over the last two years, or because the company used to be an economic powerhouse (see, for example, Nortel, Corel,

etc.) They also liken that backwards-looking approach to market *speculation*—a polite way of saying “wishful thinking.”

To identify regions that are poised for growth, sophisticated investors use the 10 economic fundamentals that will shortly be presented to you. They know that industrial development (energy developments, manufacturing plants, processing, ship-building, warehousing) fosters institutional expansion (corporate offices, health care, education). In turn, these lead to the development of commercial properties and to new and expanded transportation corridors, as well as to increased demand for the companies that support all of the people and systems needed to keep all of these economic wheels turning. At each and every step along the way, jobs are created and consumer confidence increases. In other words, with jobs you have a market; without jobs you have stagnation or worse, retraction.

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**Job Growth = Population Growth = Rental
Demand = Property Purchase Demand**

Real estate investors thus learn to listen for the news *behind* a new development. They ask:

- Where will that plant be built?
- How long will it take?

- Where will the construction crews live?
- Where will they work when this project ends?
- Where will the new plant's labour force find housing?
- How will those employees get to work?
- How might that affect where they live?
- What are the long-term prospects of this new venture?

Just the Facts

- Residential properties located within 800 metres of light rail or rapid transit stations typically can charge rents that are 5 to 11 per cent higher than the prevailing market.
- National stats mean nothing to the sophisticated real estate investor. The fact that prices are up 5 per cent across the country means nothing in a city where they've dropped 5 per cent—or have risen by 8 per cent. Ignore national stats. Focus on your chosen geographic zone.

The 10 Fundamentals of Successful Real Estate Investing

Once investors identify the geographic area they want to focus on, they need information that ensures they are well informed. Let's use a concept of a vault that stores

information. These 10 fundamentals of successful real estate investing are like the keys to that vault.

As you read through each section, remember that sophisticated investors use these fundamentals to unlock the details they need to decide if a city, town or neighbourhood has a future. Each of these keys gives you specific information to predict whether and where real estate prices can be expected to rise or fall. None of them will tell you how much prices will vary. That's information the less-educated investor chases because he forgets that real estate investment is about long-term wealth creation. Successful investors, who are in it for the long haul, use information to manage the risk.

1. Mortgage Interest Rates

Canadians love talking about interest rates. What will the banks do today? Will the government finally start raising/lowering rates? Will the housing market boom/bust when the rates skyrocket? And so on. The problem is that few understand the complex interaction between interest rates and the housing market. Most believe that there is an inverse proportional relationship: interest rates go up, ergo real estate markets go down. This is not true.

Yes, interest rates do impact the affordability of a housing market, and when interest rates rise, home owners with a variable-rate mortgage will feel the crunch more

quickly than those who are locked in. However, when you take the last 20-plus years and graph both the housing market percentage increase and the underlying Bank of Canada rate, you can see that interest rates play quite a minor role. Once again, math and statistics trump speculative talk.

We can't discount the psychological impact of a rise in interest rates. Announcements create frenzy in the market which eventually cools down as people try to get in before it is perceived to be too late. Then reality sets back in. In reality, interest rates rise and fall based mostly on the underlying economic strength of the country: hot economies generate hot job markets which generate hot real estate markets and inflation. When these occur, governments try to cool them off with an interest rate increase.

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Investors who buy and hold real estate will benefit from interest rate increases because more people will stick with renting rather than buying, thus pushing vacancy rates down and rents up.

Smart investors look for signs that will tell them the steepness of the rate changes and then make business decisions

accordingly. By using information instead of conjecture, they mitigate risks and increase profits.

This makes low mortgage rates a neutral factor for real estate investors. Low rates help them to manage their expenses and accelerate their mortgage paydowns. However, if interest rates are too low, they also help more renters become homeowners. That increases vacancy rates, meaning investors might have to work harder to make sure their properties are full.

Just the Facts

- An interest rate change to 5.25 from 5 per cent on a \$100,000 mortgage adds \$17 a month to your mortgage payment. If your investment property depends on that extra \$204 a year to either make money or break even, it probably doesn't belong in your portfolio.

2. The Disposable Income Effect

Again, look for numbers that tell the real story. Increasing average income is the greatest indicator of the net wealth effect in a region.

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**If a town's average disposable income rises faster
than the provincial average, real estate prices
are poised to do the same.**

That is why lower income tax regions often have higher retail sales per capita. More disposable income creates more jobs and builds consumer confidence. Consumer confidence is then reflected in increased demand for real estate. This correlation is why strategic investors look for regions where retail sales and consumer confidence are up, since they know it leads to a positive impact on the real estate market.

Strategic investors use this fundamental to identify potential real estate market movers before the real estate market numbers show it happening. If the average income is rising across an entire region (perhaps a province), look for indications that it is rising faster in certain cities or neighbourhoods.

The Disposable Income Effect also helps identify markets that are overheated or filled with speculators (something to avoid). Hint: if demand puts upward pressure on housing prices without a corresponding increase in average income, this strong increase is likely not sustainable. The community may have short-term investment potential for certain real

estate investors, but it won't provide the long-term sustainable market or rental increases a strategic investor looks for.

Just the Facts

- The Royal Bank of Canada produces a quarterly report on housing affordability (www.rbc.com/economics). A well-balanced market for investors has a Housing Affordability Index of 33 per cent. That means it takes 33 per cent of pre-tax income to pay for a median piece of property.
- Sophisticated investors look for cities and towns in the 25 to 39 per cent range.
- Towns and cities above 39 per cent are most likely going to under-perform over the long term as they are overpriced relative to the ability for the citizens to afford it. If the market is +6 per cent over that range, you have identified a higher-risk market.

3. Increased Job Growth

Increased in-migration to a region, town or city is one of the most important indicators of long-term sustainable markets. It has and will continue to be the foundation from which an investor's business is built. With people you have demand (rental and purchase). Without a population increase, you either have a market filled with speculators

chasing “cheap” deals or a market that is about to slip into negative territory.

This is an easy statistic to follow for your target region. Start by looking for news about people moving to your target area from other countries and other parts of Canada. Make sure they are moving there for jobs, not to retire.

Just the Facts

- REIN’s market research shows workers who relocate for jobs typically rent for three years before buying their own homes.
- Approximately 50 per cent of those relocated workers will keep renting, 40 per cent will buy and 10 per cent will move back out of the region.

4. The Real Estate Doppler Effect

At the macro level, this occurs when one city or town’s economic windfall (e.g., a new manufacturing facility or plans to increase production and employee numbers) impacts nearby cities or towns. Housing demand first rises within the community most impacted. Demand lags but will eventually increase in nearby cities and towns as the main area becomes less affordable and “too busy” for locals.

Homebuyers and investors can also take advantage of the micro-Doppler Effect. It occurs in areas that surround economically-strong communities and in neighbourhoods near those being revitalized thanks to a new development (e.g., a new post-secondary campus or a healthcare facility). As in the macro example, the revitalized area's prices and demand jump first and then ripple out to the surrounding neighbourhoods.

Just the Facts

- Write down six towns or outer suburbs where property values have not increased as rapidly as their neighbours that are closer to a particular economic hub. Find out what is happening with housing demand and prices in those outlying areas: both will likely begin to rise six months after prices increase in the more immediate area.
- Now look at neighbourhoods located near planned economic developments that are expected to or already have impacted housing demand. Has demand started to increase in these communities? Be mindful of the fact that older properties will increase faster than new ones and speculators tend to focus on new construction.

5. Local, Regional and Provincial Climates

Real estate investors make it their business to know what is going on with politics at both the macro and micro level. It is relatively easy to identify specific areas with strong economic growth, new jobs and an increased rental pool. Because “business friendly” equates to “real estate friendly,” you also need to know what local and regional politicians are doing to support that environment. Look at taxation rates for income and property. What are the laws governing landlords and tenants? How difficult is it to change zoning requirements from single- to multi-family designations? Can you meet with individuals from the local economic development office to ask about their overall plan and expectations regarding pending or future developments?

This fundamental showcases the work sophisticated investors are prepared to do to help themselves understand their market. Organizations like REIN provide additional support with research data like its annual “Top Canadian Investment Towns” report. Researchers profile more than one hundred towns before narrowing it down to those poised to outperform the others!

Will every community in that report be ideal for every real estate investor? Obviously not. But these towns are the cream of the investment crop and studying a detailed report like this is a good way to hone in on the fundamentals of what you need to know before you invest.

6. *Critical Infrastructure Expansion*

The role of transportation hubs was touched on in earlier fundamentals. It merits its own category because it exudes opportunity for the astute real estate investor who wants to know why the economic fundamentals support investment.

When a major transportation improvement is announced, look for information about why it is necessary and who will benefit. Transportation is all about accessibility and accessibility is measured in minutes-to-work. Accessibility equals increased population. Increased population equals higher demand for housing. Higher demand for housing equals upward pressure on property values and lower vacancy rates.

Consider transit, highway and air traffic changes and then watch what happens after expansion begins. Remember that speculators will buy on the announcement. Smart investors wait until the work actually begins and after they research the implications of other market fundamentals. Those other market fundamentals include increased costs for labour and materials as a direct result of in-migration and infrastructure expansion. This increases the cost of new housing construction and renovation projects.

Increased wages also drive up rents and housing prices. Investors who focus on the existing stock of real estate can make these increases work for their portfolios.

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**What really matters is a working understanding of
how the market reacts to specific fundamentals.**

Just the Facts

- Homes located within 800 metres of public transit stations will appreciate 12–15% more quickly than their market peers. Conversely, values decline more slowly if markets drop.
- Check out REIN research reports about the market impact of specific transportation projects, including detailed neighbourhood-by-neighbourhood analysis for the Vancouver area, GTA, Calgary, Edmonton and the Hamilton Tech Triangle.

7. Areas in Transition

Words such as “gentrification,” “renewal” and “revitalization” signal fundamental economic shifts in the market value of specific neighbourhoods. Real estate investors wisely watch areas with gentrification potential because they realize these are the neighbourhoods people will want to live in as the renewal takes hold and properties are often more affordable than others in the city.

Revitalized neighbourhoods are wonderful places to purchase properties with good potential for value increases

over and above the average for the city. But exercise caution: make sure the renewal is real and not a mere blip related to the announcement of a future development, be it private or public. Cash flow is often higher in these areas due to lower prices, but the tenant class may be variable. You don't want to be the first into one of these regions. The revitalization cycle can take a long time to take hold, especially if an announced development is delayed or cancelled. Wait and watch for real signs of revitalization: these include increased pride of ownership and increased demand.

Often you have to get over the reputation of a neighbourhood in these renewal areas. Remember when I mentioned earlier that a neighbourhood's past has very little bearing on what will happen in its future? An inability to grasp this point is why investors who live in or near these transition areas are likely to be the last ones to notice their potential. They can't get past a neighbourhood's bad reputation while those from outside the neighbourhood are able to view it with fresh eyes.

Revitalization, which truly begins one house at a time, often goes hand in hand with Fundamental 5, which involves political decisions regarding policing, community development and zoning. As communities gradually are transformed into places where more people want to live, investors will notice an increase in pride of ownership. Attracted by other economic fundamentals, new homeowners will move into the neighbourhood. As they start to

upgrade exterior finishes and clean up yards, other neighbours will follow suit. More expensive cars will make their debut on driveways and in the street.

Sophisticated investors watch for signs of renewal combined with other economic fundamentals discussed in this chapter.



A tougher, more hands-on tenant profile often comes with investing in these areas of revitalization, so property management and proper renovations are key.

With this negative comes the positive of higher value increases and more rapid rental increases relative to other parts of the city, a plus for long-term wealth creation.

Building on the connection between economic fundamentals, sophisticated investors realize that the Real Estate Doppler Effect works here, too. Communities next to neighbourhoods where revitalization is well underway often experience the same upward trend, but later down the timeline.

The More Active Factors

The first seven fundamentals are often called “passive” fundamentals. Real estate investors need to understand how they work as they are instrumental to one’s ability to focus

on real estate located in a particular geographic area, but are out of the investor's control. Understanding the passive fundamentals help us assess economic strength. The next three fundamentals call for some serious work on the part of the investor. That's right. This is where the successful investor takes a property—and makes it better.

8. Creating Highest and Best Use

“Highest and Best Use” is a term that professional property appraisals often use to detail what a property could be used for if it was being used to its zoning potential. The concept helps investors in two ways. First, understanding highest and best use enables you to optimize a property's value. If the zoning calls for multi-family and it is only being used for single-family housing, the smart investor finds out what he or she needs to do to change that. Similarly, if it's zoned for commercial and residential but the top floor (residence) is not being rented out (or vice versa), the investor recognizes that as an active opportunity.

Second, sophisticated investors look at whether a property is actually performing to its highest and best use. They ask questions such as:

- What is the building used for?
- What might it be used for?

- Can it be converted to condominiums or rental units?
- Could the raw land be subdivided into separate plots?
- Is this single-family home ideally situated for student housing?

More importantly, they really understand the zoning bylaws of their target region, *plus* they understand if the city has plans to change the zoning. This information all comes from city hall. Only a small number of properties on the market will prove easy to change. Others may be possible, but only with expertise and funds. Zoning changes almost always merit a second look.

Just the Facts

Be creative when it comes to determining highest and best use.

- Find out if you can rent out a garage separate from the dwelling without a zoning change.
- Put a coin-operated washer and dryer into multi-family rental unit.
- Can you charge more for parking?
- If the zoning allows basement suites, does the current homeowner have one?

- What is the potential for owning three adjacent properties and building a larger apartment building on them under new densification initiatives by the city?
- Is a university or college opening up or expanding nearby that will put upward demand on student housing?

9. Buy Wholesale, Sell Retail: Stratification

Real estate investors often think of the market in terms of their particular niche. Buy-and-hold investors buy properties to rent and keep them in their portfolio for five to seven years. Lease-to-own investors give renters a chance to buy the properties they rent, over time. The renovate-and-resell market sources properties located in high-demand neighbourhoods at bargain prices, then upgrades them for the resale market. Other investors, typically companies, buy properties at wholesale rates and sell them to investors or homeowners at retail prices.

These investors typically purchase larger multi-family properties such as apartment buildings. Armed with information about how they can rezone the property, they convert each apartment to an individual title. This is called “condominiumization” or “stratification.” A similar process

can also work with raw land, which is converted to individual lots to be sold at retail.

Stratification adds immediate value to each unit and can be extremely lucrative. But it takes deep pockets and quality legal expertise to make these deals work. I have witnessed many an unprepared investor take a heavy financial hit on properties they bought to stratify, only to learn the process costs more than they could afford or that the city has put a moratorium on conversions. Others have to hold properties for much longer than anticipated, not always a financially feasible option for individual investors.

What makes this a fundamental if these deals are so complicated? Successful stratification projects often have a ripple effect on neighbouring communities. Beautiful condominiums with professionally landscaped grounds also advance gentrification. So pay attention. Individual investors may not want to organize and finance an apartment condominiumization, but these projects often improve property values and increase rents in the surrounding neighbourhood.

10. Quality Proactive Marketing

Quality marketing is an economic fundamental that sophisticated real estate investors use to stand out from the crowd in a positive way. Proven marketing strategies attract the type of buyers, sellers, renters and money partners that add

serious value to an investor's portfolio. These strategies also make it easier for them to operate their businesses because they provide ways to maximize income by minimizing purchase prices and maximizing selling prices.

To put that in terms of dollars and cents, real estate revenues, like any investment portfolio, are all about percentages. That's why investors take great care to make sure their marketing dollars are effectively spent. Since advertising is one of their main marketing costs, they calculate a gross return on investment (ROI) to ensure their ads are profitable. If not, they change them, making the message more compelling and effective.

Calculating ROI

Cost of ad: \$250

Number of calls: 9

Number of renters: 1

Months of lease: 12

Monthly rent: \$850

Gross income from ad: \$10,200 (12 months \times \$850)

Gross ROI = \$10,200/\$250 = approximately 4,000 per cent¹

¹By using this formula, the investor knows that every time the phone rang, the call was worth \$1,133.

Conversely, you don't want your ads to attract too many unfiltered calls. Answering questions that should have been answered in your ad wastes your time! What really matters is the *quality* of the potential renter or buyer who calls.

Of course, marketing is about more than advertising. Sophisticated investors know that every dollar they invest in a property needs to come back to them—times at least three. If your property can attract a 5 per cent rent premium over the current market, that equals \$42.50 on a monthly rental rate of \$850.

Your goal is to be at the top of the rental food chain—and to get there effectively and inexpensively. The real gravy comes when you choose your regions well (population growth, area of renewal *and* a new transit station within 800 metres of your property) and renovate the property to appeal to the more discerning renter (simple things like nice flooring, a feature wall and an updated bathroom). All of these factors can easily lead to you receiving 10 to 15 per cent above average market rents. In our example, that equals a minimum of \$85 per month times 12 months. That's an extra \$1,020 on your bottom line—just by being a smart marketer. Now take it a notch further and imagine you have 10 properties like this. Not bad! Over and above the positive cash flow you are already receiving, you're getting an extra \$10,200 to do with what you like.

Just the Facts

- Marketing is a science unto itself. Successful investors understand the importance of clearly communicating in all aspects of their business, and marketing plays a major role. Whether attracting capital to complete deals, going to a bank to get financing or attracting great tenants, mastering marketing is critical.
- These strategies are so important that we regularly discuss and share with our REIN members what works and what does not.
- Landlording Secrets—The Definitive Tenant and Property Management System, is a REIN home-study course that really focuses on marketing strategies for investors.

The 10 factors we've discussed drive real estate markets up and down. As you review them, you will see that they are often interconnected. The more of these factors your target region has in your favour, the less risk and more reward you can expect to receive. If there are only one or two factors in your favour, expect high risk and lots of real and potential headaches. Many factors? Well, that tells me you have identified a strong and long-term sustainable

market that, even with the inevitable gyrations of the market, will serve you well.

Take the business section of your local daily newspaper and try to link as many fundamentals as you can to particular news stories. Each of these fundamentals has an economic impact on real estate markets. When they act in concert, they are especially powerful.

The Pseudo-Fundamentals

I want to draw special attention to the importance of two investment strategies that masquerade as fundamentals. Their execution can be considered a sophisticated strategy. But more often than not, their execution is far from sophisticated. When people ask why real estate investment makes sense, these two pseudo-fundamentals merit thought—and caution.

1. Renovations and Sweat Equity

This is more of an investment strategy than an economic fundamental. Still, it operates as a fundamental because it can impact markets.

Let me explain. Many real estate investors get their start in the business by buying and renovating properties, which they then flip back onto the resale market. A plethora of television shows has helped promote this approach,

and while it can work, investors must go into these projects with their eyes and ears wide open! To be honest, that doesn't happen nearly enough, which is why veteran investors view this part of the market with a certain amount of caution. They know it can work. That is, there is money to be made. They also know this segment of the market attracts a lot of first-time investors and a lot of speculators. That makes it a market segment dominated by inexperience and emotion. It is a strategy not to be followed without a proven system.

Success with the fixer-upper strategy is highly dependent on buying the right property, having the right trades ready and knowing a lot about marketing, renovations, economics and real estate. Those who do it well focus on well-built but somewhat neglected properties in neighbourhoods where the revitalization fundamental is already kicking into gear. These properties could also be located adjacent to neighbourhoods where demand is rising thanks to changes to transportation systems or economic developments that improve employment and wages. In other words, success depends on the strength of the 10 fundamentals. The more fundamentals a particular property has, the stronger its potential for the fix-and-resell market.

Investors who make this strategy part of their real estate business know not to mix these transactions in the

same company as their long-term rentals. The short-term flips are treated as income for tax purposes, while long-term holds are more likely to be considered capital gains if they are ever sold in the future. Mixing them can lead to you losing the capital gains tax savings, if you are not careful.

Success in this renovation-and-flip market segment demands honesty. The investors must be honest with themselves about the first 10 market fundamentals, honest about how much renovations really cost, honest about the price they'll get when they sell and honest about a Plan B if the property *doesn't* sell.

~

Because inexperienced and emotional investors tend to overestimate their final selling price and underestimate the real cost of the renovations, this strategy is fraught with trouble for beginners.

If you're thinking of fixing and flipping, make sure you first get good advice. Learn how to keep these projects simple by finding properties that need cosmetic changes, not structural improvements. It can be done well and profitably. If not done well, it can cost you your business.

Just the Facts

- Talk to your tax professional before you launch a renovate-and-resell deal. Properties bought for a long-term buy-hold-rent strategy are usually taxed as capital gains (i.e., only 50 per cent of the profit is taxed at your tax rate). Under Canada Revenue Agency (CRA) rules, profits made with the renovate-and-resell strategy will be taxed fully as business income. That's on 100 per cent of the profit (not 50 per cent).
- Property in this category can also be deemed as inventory. This provides the potential for the CRA to disallow the carrying costs of the property while you renovated it, meaning you cannot write off mortgage interest or any other carrying cost. Ouch! That doesn't make the deal untouchable, but it can give it a substantially less profitable bottom line. Get great tax advice before you take action!

2. Speculation

This investment strategy also masquerades as an economic fundamental by focusing on the myth of the great deal. Since speculation implies exclusive information, it often defies the truths of the first 10 fundamentals. The problem

is that the information investors act upon is often based on gossip (at best) and on misinformation (at worst)! For example, good news stories like announcement of the 2010 Vancouver Olympics definitely helped some speculators make money in that region when they bought ahead of the crowd. The opposite happened in Hamilton where speculators bought properties based on the proposed location of a new stadium—and lost that money when the stadium wasn't built.

There is no question that speculators with quick access to cash are often able to jump in and buy property at great prices when they act on insider or just-released news of a major economic development. In cases where the development proceeds, these investors can make a lot of money. But let me be clear about the fact that this kind of purchase does not make them real estate investors, as such. It makes them speculators. Lucky speculators.

Speculation is not part of the ACRE system. All 10 of the economic fundamentals discussed, from critical infrastructure improvements, to interest rates, in-migration, the net wealth effect and quality marketing, etc., comprise a basket of market fundamentals that investors can analyze to help them build long-term wealth. In contrast, speculation is all about rolling the dice. Sometimes it works and many times it doesn't. A strategic investor always looks at ways to reduce risk and increase returns.

Just the Facts

- Successful real estate investors evolve with education and experience. They learn to look for clues in all the right places. Always seek out business and political information that makes your business stronger. Join an investment network and look for ways to learn from success.

Closing Deals, Making Money

Why does real estate investing make sense? Because it can be predictable, long term and provide regular income along with increases in net worth. But you have to follow a system and you must pay attention to real estate numbers and the important fundamentals that will tell you where those numbers are headed.

When I started investing in real estate, I knew very little about the market. But I dove in and became a voracious learner. Once I knew the useful tips and basic strategies, I jumped in deeper and built my portfolio, making some mistakes along the way and learning to minimize risks and increase profits. But it all started with nothing. Which is why I am so confident that successful real estate investment is a learned skill and why the ACRE system

exists for investors. I sure wish I had it when I was starting out.

Now that the foundation is laid and you understand how to identify and analyze the market clues we call the economic fundamentals of real estate investing, hold on as we go back in time to look at what my earliest years as an investor were really like...

Pocket Gold

Keep a copy of this Property Goldmine Scorecard in your car or on your smartphone and use it to practise the fundamentals of property analysis. This is the kind of due-diligence tool investors use to help them gauge the economic fundamentals of a particular property.



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INVESTMENT
NETWORK™

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Property Goldmine Score Card

Property Address: _____

Town: _____ Prov: _____

Source: _____ Tel: _____

Property Specific Questions

- Can you **change the use** of the property?
- Can you buy it substantially **below retail market value**?
- Can you substantially **increase the current rents**?
- Can you do small **renovations** to substantially increase the value?

Area's Economic Influences

- Is there an **overall increase in demand** in the area?
- Are there currently **sales over list price** in the area?
- Is there a noted **increase in labour and materials cost** in the area?
- Is there a lot of **speculative investment** in the area?
- Is it **an area in transition** – moving upwards in quality?
- Is there a major **transportation improvement** occurring nearby?
- Is it in an area that is going to benefit from the **Ripple Effect**?
- Is the property's area in **"Real Estate Spring or Summer?"**
- Has the **political leadership** created a "growth atmosphere"?
- Is area's **average income increasing** faster than provincial average?
- Is it an area that is attractive to **"Baby Boomers?"**
- Is the area **growing faster** than the provincial average?
- Are **interest rates** at historic lows and/or moving downward?

_____ = Total ✓'s

Does This Property Fit Your System?

yes no

Does It Take You Closer to Your Goal?

yes no

