

Understanding Real Estate Investment

Many Canadians have become financially secure by investing in real estate. The skills they have employed to safely and prudently invest in real estate can be learned and practised. This book will provide you with that knowledge so that you can make informed decisions about investing in real estate, plan the increase in your net worth, minimize risks, maximize profits, and enjoy the attainment of a personal challenge.

Many Canadian households have a net worth that exceeds \$1 million. Most of the people who live in these households, unless they have inherited money or been successful business owners, owe their financial wealth to real estate. In many cases, the wealth has been accumulated simply through owning a principal residence for 25 years or longer and carefully tending to their pension plans. Many of the millionaires—who are 55 to 65 years of age, and have worked at relatively ordinary jobs—live in Toronto, Calgary and Vancouver, where real estate value has increased substantially over the years. They have accumulated their wealth due to inflation in real estate on their tax-free principal residence and the tax-free compounding of their RRSPs.

As you can see, there are distinct advantages to starting your real estate investment by purchasing a principal residence, so that you can get into the market and start benefiting from the growth of tax-free equity. Statistics from the Canadian Real Estate Association show that the average compounded annual increase in real estate value through MLS listings nationally has been 5% a year over the past 25 years, since 1980. Depending on the real estate cycle at any given time, the geographic location and type of property, the percentage annual increase could be substantially higher of course. Residential real estate appreciates more than the annual rate of inflation over time.

This first chapter will help you in understanding the real estate market. 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 your self-confidence, your "street-smarts," and improve your chances of making the right choices.

This chapter covers investing in real estate, understanding the real estate market, establishing your investment strategies, buying with others, and avoiding the pitfalls.

Advantages of Real Estate Investment

Here are the main advantages that make real estate investment, compared to other types of investments, attractive. As mentioned earlier, many are inter-related. There are also some disadvantages, which will be discussed later.

Low Risk Compared to Other Investments

Any investment has a potential risk, and you can indeed lose money in real estate. The reasons why will be covered in this book. Real estate, however, has traditionally been a secure, stable investment compared to other investments, especially if you buy prudently and carry out due diligence. There are various reasons for the relatively low risk, which naturally will vary depending on the geographic area, stability of the market, and other factors. These reasons include increases in population density a scarcity of land for development, interest rate stability and flexible financing terms, the intrinsic need and demand for residential real estate, and consistent history of land value appreciation exceeding inflation. The market is cyclic and, depending on location and other factors, eventually will increase.

Minimal Starting Capital

You can make a real estate purchase with a minimal amount of money, possibly only \$5,000 to \$10,000, and borrow the rest using the property as a security. For example, you could buy a condominium for \$150,000, put 10% down (\$15,000), and finance the balance (90%). This is called high-ratio financing, where the ratio between the debt (mortgage of 90%) and equity (your down payment of 10%) is high. You will be required to take out high-ratio mortgage insurance (explained in greater detail in Chapter 5: Understanding the Financing Aspects) through Canada Mortgage and Housing Corporation (CHMC). It is even possible to borrow 100% of the purchase price.

Investment Skills Can Be Learned

Compared to other investments, buying your own home can be a relatively easy process. You don't need a lot of experience. It just takes motivation, drive, and a desire to acquire the knowledge and skills. The fact that you are reading

this book clearly shows that you have the necessary attitude. Naturally, if you are buying real estate for investment other than your principal residence, more knowledge and skills must be acquired. The essential knowledge will be covered in this book.

Investors Do Have a Life

Investing in real estate need not take up all of your free time. Once you learn the techniques, you will be more efficient, selective, and confident, which will save you time. You should decide at the outset how much time you are prepared to spend researching the market, and negotiating for, buying, managing, and selling properties. If you find yourself spending more time than you want to or have available on your real estate dreams, you have to analyze the causes and fix them. Various strategies are provided in later chapters.

Using Leverage

The concept of leverage simply means using a small amount of your own money and borrowing the rest—using other people's money (OPM). Many people have become wealthy by applying the OPM principle of leverage. The discussion under "Minimal Starting Capital" provided an example of a highly leveraged investment. Basically the ratio was 9:1; that is, nine times as much money was borrowed as invested. 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 after the sale should at least cover the amount of the mortgage, especially considering historical appreciation in value.

If the investor leverages up the property too high (that is, has a high-ratio debt of, say, 95%), and the market moves into a declining part of the cycle, then the investor and the lender could be at risk. That is why the higher the amount of the mortgage, the greater the risk for the lender and therefore the higher the interest rate paid by the borrower unless the mortgage is insured. For example, if you are buying a \$100,000 property and have three mortgages—the first at \$75,000, the second at \$10,000, and the third at \$5,000—the interest rates could be 5%, 7%, and 10%, respectively. The last mortgage has the highest risk because it is the last to be repaid upon the sale of the property. On the other hand, if you have a first mortgage that represents 90% of the purchase price, and it is insured against default and loss as a high-ratio mortgage, your interest rate could be the basic 5% in the above example. The two companies that insure high-ratio mortgages are CMHC (www.cmhc-schl.gc.ca), and G.E. Mortgage Insurance Canada (www.gemortgage.ca).

Here is another example to show the power of leverage. Let's say you bought a house for \$100,000, put down 10% (\$10,000), and borrowed 90% (\$90,000). The home appreciated by 10% over a year in this scenario. What would be the return on your original investment of \$10,000? The answer is 100%. In other words, the increase in the value of your home of \$10,000 (10% appreciation of the \$100,000 original price) is a 100% return on your down payment investment of \$10,000. Conversely, if you put all your own money into the home—that is, \$100,000—your return on your original investment, due to appreciation of 10% over the year (\$10,000) would be 10%.

A related concept to leverage is pyramiding, in which you would borrow on the increasing equity (due to appreciation) of your existing properties, applying the principal of leverage to buy even more properties over time. This compounding effect of equity buildup through appreciation in a prudently selected real estate portfolio can result in the accruing of considerable wealth.

Appreciation

This term simply means the increase in value of the property over time. It is the growth in value of your original capital investment. As mentioned earlier, the national average has been approximately 5% per year. As a note of caution, it should be stressed that it is an *average*. Certain geographic areas or locations will be less than the average, 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 go up as much as 25% or more 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. (See the section on real estate cycles, page 9.)

Equity Buildup

When you make payments on your mortgage, you are paying down the principal over time. As you reduce your debt, you build up your equity—that is, the portion of your original house price on which you no longer owe any debt. 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 actual equity is what you would net upon the sale of the property, after all real estate commissions and

closing costs are taken into account. Lenders understand this, which is why they generally do not like to base a loan on more than 90% of the equity in order to minimize risk and leave a margin for safety in the event that the loan goes into default and a forced sale is required. Under the federal *Bankruptcy Act*, all first mortgages over 75% of the appraised value or purchased price, whichever is lower, must be insured by high-ratio insurance. However, in certain situations, CMHC will provide purchasers who qualify with insurance on a mortgage up to 100% of the purchase price of a principal residence, with some conditions, of course. If borrowers want more money than what is available under a first mortgage, they would need to obtain additional funds from a lender in the form of second or third mortgages.

Inflation Hedge

You are probably well aware of the concept of inflation. As a review, inflation means the increasing cost of buying a product or service. In other words, it is the decrease in your purchasing power; for example, an item that cost \$1 ten years ago now costs \$10. People on fixed incomes that are not indexed (increased) for inflation are very aware of the erosion of the purchasing power of the dollar. The inflation rate in Canada varies at different times of the year and in different regions across the country. At one time Canada had double-digit inflation, but currently has a policy of keeping inflation single-digit and as low as possible.

Naturally, the appreciation of property value over time includes an inflation factor. Historically, land appreciation value for residential homes has been approximately 4% to 5% greater than the inflation rate. Another benefit of real estate investing is that you are paying off the mortgage in inflated dollars. That is, you are probably getting more money now in terms of salary increases to pay off lesser-value money 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. Many of these are covered in Chapter 7: Understanding the Tax Aspects. It would be hard to find another investment that has as many benefits as real estate. For example, all the interest you receive from your bank account, term deposit, or guaranteed investment certificate (GIC) is fully taxable as income. So, if you are obtaining interest of 6% (the nominal rate) on your deposit, and the inflation rate is 4%,

the “effective” or “real” rate of return is 2%. If you are paying tax at a 35% rate (2% based on the 6% nominal rate), then effectively you have a zero, or possibly negative, rate of return on your money. In practical terms, taking inflation and taxes into account, you have lost on your investment in bank deposits. Real estate does not have this problem, so wisely investing in real estate—starting with a principal residence—is clearly an attractive form of investment.

Some of the key tax advantages of real estate investment include the following:

- ✓ tax-free capital gain on your principal residence
- ✓ ability to write off principal residence suite rental income against your home expenses
- ✓ 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)
- ✓ reduced tax rate of 50% 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
- ✓ write-off of depreciation of the building against income

Income Potential

A prudent real estate investment can 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. Not only can the income provide you with additional money, but the fact that you have a positive cash flow is one factor that automatically increases the value of income-producing real estate, sometimes very substantially. 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—before and 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 criterion.

Increasing Demand for Land

Due to increasing population and a decreasing supply of land, real estate prices go up. Many communities have slow growth or no-growth policies because they cannot meet 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 place of retirement. This creates further demand for land.

Disadvantages of Real Estate Investment

To provide some balance, there are some limitations to investing in real estate, but if you are aware of these limitations, you will be able to invest 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

Some people make decisions based on emotion rather than sound preparation, knowledge, and objective assessment, particularly when buying their first home. After you read this book, that problem should not affect you.

Lack of Liquidity

This means that you can't convert your real estate investments into cash quickly, as far as a sale is concerned, because many factors have to be taken into account. You could have the option of borrowing on your property, though.

Extended Holding Period

Most real estate investments are held for long periods, for example, 5 to 10 years. You will have to wait some time, therefore, to get your return on your investment. However, there are alternative investment options in terms of time. Some of these are discussed in later chapters.

Time Expenditure

The investment could take up 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

The potential for high risk, of course, 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

The very nature of real estate makes comparing two or more properties difficult because each property is unique. On the other hand, there are rules of thumb and other formulas that are effective, especially in combination. These are explained in detail later in this book.

Exposure to Government Control

Governments at all levels have an impact on real estate. There are government laws and regulations covering a wide range of areas, including planning, zoning bylaws, use of property, building codes and licences, rent controls, property transfer taxes, and environmental regulations. In addition, governments can expropriate and require rights of way. All these factors could certainly affect 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.

Understanding the Real Estate Market

In order to have a better appreciation of how the real estate market operates, and how to operate prudently within that market, you need to understand the cycles and factors that influence prices. The market is a fluid, dynamic entity, and no buying or selling decisions should be made without an accurate market assessment.

The Real Estate Cycle

Real estate is a cyclical industry. As in any such industry, the cycle historically creates shortage and excess, which is related to supply and demand in the marketplace. Too much supply creates a reduction in value. Too little supply creates an increase in value. It is essential to know where you are in the cycle relative to the property you are considering to purchase. It is also important to appreciate that different provinces, regions, and communities are in different parts of the economic cycle. Timing in the cycle is important when making buying and 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 consequent glut occurs and the demand is not there, prices come down as houses and condominiums go unsold. The phases of the real estate cycle will be discussed later in the chapter.

External Factors that Can Affect the Real Estate Market

General Business Economic Cycles

The economy historically goes through periods of increased economic growth followed by periods of recessions. The economic impact is greater, of course, in certain parts of the country than in others in any given cycle. In a recession, people lose their jobs and have to put their houses on the market. Real estate prices become depressed 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. (See the section on obtaining information in Chapter 3: Finding and Evaluating the Right Property.) Later in this chapter other indicators to look for will be discussed. If the economy has been in a recession for a sustained period, there could be opportunities to buy. Once the economy comes out of a recession, prices tend to climb. Conversely, if the economy has been on a buoyant growth trend for an extended period, be very cautious in purchasing because a change in the cycle, and therefore a drop in real estate prices, could be imminent.

Local Business Cycle

Each local economy has its own cycles and factors that affect real estate prices. These factors may not be greatly influenced by the general (provincial or national) business cycles just discussed.

Community Cycle

Certain geographic locations within a community can have their own economic cycles as well as 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 rehabilitation. Look for areas of future growth.

As you can see, being aware 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 affect the cycle of the real estate market. Different types of real estate—for example, condominiums, new houses, resale houses, and small apartment buildings—can be at different points of a cycle.

There are four distinct segments to a real estate cycle. Each of these segments has certain identifiable characteristics and therefore helpful clues for assessing the state of the real estate cycle. (Refer to Chart 1 in the Appendix.)

Three Types of Real Estate Markets

You undoubtedly are familiar with the common terms used to describe the three types of real estate markets. As a brief review, they are:

Seller's Market

In a seller's market the number of buyers wanting homes, for example, exceeds the supply or number of homes on the market. This type of market is characterized by homes that sell quickly, an increase in prices, a large number of buyers, and a minimal number of available homes. These characteristics have implications for the buyer, who has to make decisions quickly, must pay more, and frequently has his or her conditional offers rejected.

Buyer's Market

In a buyer's market the supply of homes on the market exceeds the demand or number of buyers. Characteristics of this type of market include a longer selling period for homes on the market, fewer buyers compared to the number of available homes, more homes for sale, and a reduction in prices. The implications for buyers in this type of market are more favourable negotiating leverage, more time to search for a home, and better prices.

Balanced Market

In a balanced market, the number of homes on the market is equal to the demand or the number of buyers. The characteristics of this type of market include a reasonable selling period for houses on the market, demand that equals supply, sellers who accept reasonable offers, and stable prices. For the buyer in this type of market, the atmosphere is more relaxed and there are more homes to choose from.

Factors that Affect Real Estate Prices

There are many factors that influence the price of real estate. Whether you are a buyer or seller, you need to understand which factors are affecting the market so you can make the right decisions at the right time and in the right location. Many of these factors are interrelated.

Position in the Real Estate Cycle

As described in the previous section, the position of the particular real estate market in the cycle will have a bearing on prices.

Interest Rates

There is a direct connection between interest rates and prices. The higher the rates, the lower the prices. The lower the rates, the higher the prices. When the rates are low, more people can afford to buy their first home or an investment property. This puts pressure or greater demand on the market.

Taxes

An area of high municipal property taxes can be a disincentive to a purchaser. A rise in taxes could cause real estate prices to drop. Provincial taxes, such as a property purchase tax or speculators' tax, will limit the number of buyers. Federal tax legislation on real estate, such as a downward change in capital gains tax, could have a negative influence on investors. All these factors would affect the overall amount of real estate activity, as well as prices.

Rent Controls

Naturally, provincial rent controls and related restrictions could have a limiting effect on investor real estate activity, thereby resulting in fewer buyers in the market for certain types of homes. Rent controls are set and governed by provincial legislation. Not all provinces have rent control, but any province can introduce them or modify their existing legislation at any time. To find out whether there are caps on rent increases, check out the landlord/tenant legislation in your province. Go to www.google.ca and then type in the key words "landlord tenant law" and the name of your province. If your province has rent controls, you will see the criteria for increasing rents, including any special permitted circumstances for additional rent increases.

Economy

Confidence in the economy is important to stimulate homebuyer and investor activity. If the economy is buoyant and the mood is positive, more market activity will occur, generally resulting in an increase in prices. Conversely, if the economy is stagnant, the opposite will occur, resulting in decreased homebuyer and investor activity and lower prices. If real estate purchasers are concerned about the same problem, a predictable loss of confidence occurs in the market.

Population Shifts

A geographic location with attractive business, employment, tourism, and retirement opportunities will attract immigrants from outside the country and emigrants from other provinces. The increased demand will increase property prices. Conversely, if there is net migration out of the area due to closure or potential closure of industry, environmental problems, or other factors, prices will go down.

Vacancy Levels

High vacancy levels could reduce investor confidence due to the potential risk, and real estate sales could go down. On the other hand, low vacancy levels could stimulate investor activity as well as first homebuyers. 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

This is an important factor. Highly desirable locations will generally go up in price more quickly and consistently.

Availability of Land

A natural shortage of land, municipal zoning restrictions, limits on development, or provincial land-use laws that restrict the utilization of existing land for housing purposes will generally increase prices. Again, it relates back to the principle of supply and demand.

Public Image

Public perception of a certain geographic location or type of residential property or builder will affect demand and therefore prices. Some areas or types of properties are "hot" or trendy, and some are not at any given time.

Political Factors

The policy of a provincial or municipal government in terms of supporting real estate development will naturally have a positive or negative effect on supply and demand and therefore prices.

Seasonal Factors

Certain times of year are traditionally slow months for residential real estate sales, so prices decline. The same seasonal factor affects recreational property. There are ideal seasons for purchase and sale.

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 various steps in the process of determining your plan. Completing a self-assessment is step 1. Determining your current financial need is step 2. Assessing your future personal and financial needs is step 3. And step 4 is planning your investment strategies.

Step 1: Personal 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. Your self-assessment will identify your areas of interest as well as skills, attributes, and talents that are relevant to the business of real estate investing.

Step 2: Determine Your Current Financial Status and Needs

To obtain this review, complete Form 1: Personal Cost of Living Budget (Monthly) and Form 2: Personal Net Worth Statement (see Appendix). Then complete 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 is an essential step, as it 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:

- ✓ Thoroughly research the market before making any decision. 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%) unless, of course, you can only obtain a maximum of 75% 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: Negotiating Strategies.
- ✓ 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 minimum.
- ✓ 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).

- ✓ As a general rule of thumb, buy investment properties within four hours' driving distance of 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: Real Estate Assessment Checklist, 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% of business partnership 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 (e.g., five years) with positive cash flow from rents; others may want a medium-term investment (e.g., 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.* You therefore should 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 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% consent

is required; and in still other cases, a simple 51% majority vote of investors is required. 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% 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% 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, you would also want to consider including the following points in an agreement:

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

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 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 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 continues. 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 are comprised of a small number of people, generally not more than ten.

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 (e.g., 10% to 25%). 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 match of investor/tenant, 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 eight to ten 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 (e.g., 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.

Pitfalls to Avoid

It is probably timely, at this early point in the book, to outline some of the classic pitfalls to avoid in buying real estate. In most cases, investors who have problems have succumbed to a combination of the following traps. Being aware of these problems at the outset will help you place the discussion and cautions in the rest of the book in context. All these issues are dealt with throughout the book.

- ✓ not having an understanding of how the real estate market works
- ✓ not having a clear understanding of personal and financial needs

- ✓ not having a clear focus or a realistic real estate investment plan, with strategies and priorities
- ✓ not doing thorough market research and comparison shopping before making the purchase
- ✓ not selecting the right property, considering the potential risks, money involved, and specific personal needs
- ✓ not verifying representations or assumptions beforehand
- ✓ not doing financial calculations beforehand
- ✓ not buying at a fair market price
- ✓ not buying real estate at the right time in the market
- ✓ not buying within financial debt-servicing capacity, comfort zone, and skills
- ✓ not understanding the financing game thoroughly, and therefore not comparison shopping and not getting the best rates, terms, and right type of mortgage
- ✓ not making a decision based on an objective assessment but on an emotional one
- ✓ not determining the real reason why the vendor is selling.
- ✓ not having the property inspected by a building inspector before deciding to purchase
- ✓ not selecting an experienced real estate lawyer and obtaining advice beforehand
- ✓ not selecting an experienced professional tax accountant when selecting real estate property, and obtaining advice beforehand.
- ✓ not selecting an experienced realtor with expertise in the type of real estate and geographic location you are considering
- ✓ not negotiating effectively
- ✓ not putting the appropriate conditions or “subject clauses” in the offer
- ✓ not buying for the right reasons—in other words, buying for tax shelter reasons rather than for the inherent value, potential, and viability of the investment property
- ✓ not independently verifying financial information beforehand
- ✓ not obtaining and reviewing all the necessary documentation appropriate for a given property before making a final decision to buy

- ✓ not selecting real estate investment partners carefully
- ✓ not having a written agreement with real estate investment partners prepared by a lawyer
- ✓ not detailing exactly what chattels are included in the purchase price
- ✓ not seeing the property before buying it, but relying on pictures and/or the representations of others
- ✓ not managing the property well, or not selecting the right property management company
- ✓ not selling the property at the right time in the market or for the right reasons.

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, buying with others, and avoiding the classic pitfalls. Now it's time to look at specific types of residential real estate.