

Sound choices for income property investors.



There's perception and then there's reality

- Making sound money choices is all about closing the gap between perception and reality.
- As a potential income property investor, it's a good idea to evaluate any real estate decision through the lenses of: **perspective**, **prudence** and **balance**.
- Think of income property real estate as an investment that should deliver an acceptable return and predictable income.

1) Gain perspective – investment returns

Declining returns: Average annual returns on Canadian residential income properties have plummeted from 12.4% in 2001 to 5.1% in 2003 as the residential real estate market has strengthened¹.

2001	2002	2003
12.4%	9.9%	5.1%

2) Emphasize prudence – manage your risks

Beware of rising vacancies: Enthusiasm to purchase real estate by the general public, and especially first time homeowners, has diminished the pool of available renters in most major cities. Results from Canada Mortgage & Housing Corp.'s 2003 Rental Market Survey indicates that rental apartment vacancy rates in the majority of Canadian Census Metropolitan Areas (CMAs) increased between 2002 and 2003. Vacancy rates increased in 10 of the 11 CMAs throughout 2003¹.

Housing cycles matter: As home prices rise (as has been the case in the last few years), residential income property investment returns tend to decline, since the two are counter-cyclical.

Deteriorating physical condition of properties: One of the main disadvantages when considering income properties is the generally deteriorating condition of

existing Canadian rental stock¹. You need to pay careful attention to the capital investment an income property will require, as this is a major factor affecting return on investment.

Escalating upkeep costs: You need to ensure that adequate maintenance and repair costs are factored into the expected return. Capital repair data in Ontario show that the repair costs of rental units have increased significantly from approximately \$1,000 five years ago to currently well over \$2,000 per year today².

"Location, Location, Location": When considering location, you should be careful, as rental markets are not homogenous and even tight markets can have pockets of under performing market conditions.

Size matters: The majority of rental household demand focuses on one or two bedroom units that are reasonably priced; larger, more expensive units make up less than 10% of all rental units².

3) Stress balance – real estate and your other assets

30% rule: Generally, as a good rule of thumb, the value of your real estate minus your mortgage should make up no more than 30% of your total assets².

Asset diversification: Real estate offers an additional level of diversification in any portfolio – however, be careful not to overdo it.

¹ 2004 Clayton Research based on ICREIM/IPD Canadian Property Index data and Russell Canadian Property Index data (pre 2000).

² 2004 Clayton Research based on data from Statistics Canada.

Make a real estate decision tailored to you

Any prudent decision involving income property real estate needs to be right for you. Below are some simple exercises to help guide you towards making sound choices on real estate decisions.

A) Ensure your assets are balanced

The large amount of money required to purchase income property means that you should consider real estate as part of your overall wealth. It should be balanced against other asset classes – stocks, bonds and cash – to ensure steady, even gains in your portfolio. As a guideline, the average Canadian household has approximately 28% of its net worth in real estate in 2003¹.

	YOUR CURRENT ASSET MIX		YOUR PROJECTED ASSET MIX	
	ACTUAL \$	%	ACTUAL \$	%
VALUE OF REAL ESTATE <u>MINUS</u> YOUR MORTGAGE	_____	_____	_____	_____
CASH/GICs	_____	_____	_____	_____
BONDS AND FIXED INCOME MUTUAL FUNDS	_____	_____	_____	_____
STOCKS AND EQUITY MUTUAL FUNDS	_____	_____	_____	_____
OTHER TANGIBLE ASSETS	_____	_____	_____	_____
TOTAL ASSETS	_____	_____	_____	_____
RATIO OF NET VALUE OF REAL ESTATE / TOTAL ASSETS	<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 30%		<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 30%	

B) Measuring returns on income properties

ANNUAL REVENUE FROM INCOME PROPERTY:	_____
SUBTRACT: – MAINTENANCE / REPAIR EXPENSES*:	_____
– PROPERTY TAXES	_____
– UTILITIES	_____
– INTEREST PAYMENTS	_____
= NET OPERATING INCOME PER YEAR	_____
PURCHASE PRICE:	_____
PLUS : + CAPITAL INVESTMENT / MAJOR RENOVATIONS	_____
+ APPLIANCE EXPENSES	_____
= TOTAL INVESTMENT	_____
ROI - RATIO OF NET OPERATING INCOME/ TOTAL INVESTMENT:	<div style="background-color: #d9ead3; width: 100px; height: 20px; margin: 0 auto;"></div> RULE OF THUMB: 8-10%

* Average in the \$2,000 - \$2,500 range per year (assume 10 - 20% increase per year).

¹ 2004 Clayton Research based on data from Statistics Canada.

