

Introduction to Real Estate: Lesson 1

Real Estate Investment (REI)

The purpose is to buy land and all physical properties attached to it, such as houses, trees, fences and so on; in order to generate income by selling or renting it.

REI Cycle: experiences excess when supply of properties is high, this results in a decrease in property values and indicates a good time for you to buy, but not to sell.

Factors Affecting the Market: interest rates, taxes, legal restrictions, local or provincial economy, population mobility, vacancy, property location, and public opinion of the property.

Advantages:

- Low risk
- Real estate appreciation increases annually
- Down payments are accessible (up to 90% of purchase price can be covered by financing)
- Net return will likely be high
- Tax rates are beneficial to REI – Canadian laws allow contributors several advantages that go from tax-free to tax savings on capital gains
- REI builds up on equity – mortgage payments mean acquiring equity, that is clear of debts

Disadvantages:

- Basic knowledge is essential to making sound decisions
- Cash is not available immediately – buyers and borrowers are needed to turn investments into cash, which can take some time
- REI is a long-term investment – this means waiting 5-10 years before selling the property in order to see the expected return
- Advice from experts is necessary

Major Participants in the REI Process:

1. Equity Investor: the person or entity that acquires the real estate investment.
 - Individual
 - Corporation
 - Partnership
 - Real Estate Investment Trust (REIT)
2. Mortgage Lenders: the entity that lends the money that the equity investor needs to start an REI.
 - Another individual
 - Insurance companies
 - Banks
 - REIT
3. Tenant: the one who buys the right of possession and use of a property from the equity investor.

- Residential
- Commercial
- Industrial
- Special purposes (theatre, sports, reception halls, etc.)
- 4. Government: regulates the relationship between participants, and restricts participants with the imposition of taxes.
 - Federal
 - Provincial
 - Municipal

Relationship between REI Participants:

1. Equity Investor & Mortgage Lender
 - The equity investor borrows money from the mortgage lender
 - The mortgage lender expects payments that will include the principal, plus interest generated through time
 - The lender gets a mortgage document as collateral: states the method of payment (could be repayment of interest first and principal at the end, or the repayment of both principal and interest in each amortization)
2. Equity Investor & Tenant
 - The equity investor leases the right to use a property to the tenant
 - The tenant pays rent to the equity investor to use the property
 - The lease document establishes the attributions and restrictions involved in using the property
3. Equity Investor & Government
 - The equity investor pays taxes to the government
 - The government sets restrictions on owners (such as police power, taxation and eminent domain)
 - The police may enter a property without requiring the owner's permission
 - Most taxes are income on capital gains. The taxes on income are for money made on rents received from tenants. Taxes on wealth are for gains for selling a property. The government also requests a "welcome tax" and "goodbye tax" for buyers and sellers of a property
4. Mortgage Lenders & Government
 - The mortgage lender's relationship to other participants in the REI is regulated by the government
 - The government imposes restrictions on mortgage lenders which will depend on the nature of the mortgage lender (restrictions on banks are different than those on corporations)
 - The government also sets mortgage laws on debt service or mortgage payments for equity investors
5. Government & Tenant
 - The government regulates the use that the tenant can make of the property on lease
 - Landlord-tenant law has evolved to detail legal aspects and actions that tenants can take to protect the property

The Real Estate Investment Process:

Step 1 – Identify investor's objectives, goals and constraints

- The equity investor: interested in the cash flow that will generate the REI
- The mortgage lender: goal is to obtain a rate of return from the money lent to the equity investor
- The tenant: concerned with the legal rights to use the property
- The government: responsible for regulating relationships and placing restrictions on the real estate

Step 2 – Analyze investment climate and market conditions

- The market environment: identifies supply and demand in the real estate market at local, provincial and state levels and how they affect the REI
- The legal environment: Analyzing the legal opportunities and limitations that an REI might entail will play an important role in the acquisition decision and the rest of the REI process
- The financing environment: The analysis of the cost of debt or interest rate, and the cost of equity or rate of return, shows how feasible the REI is and how profitable it might be
- The tax environment: Taxes decrease the REI's income, therefore knowing the taxation system and its impact will help to make the right decision to save money or increase gains

Step 3 – Develop financial analysis

- At the end of the analysis, you will be able to answer such questions as: How much is profit per year? How much is the mortgage payment? How much is the capital gain when I sell? How much will taxes diminish my profit? How much will taxes decrease my capital gains? What strategies should I use to reduce taxes on profits and capital gains?

Step 4 – Apply decision-making criteria

- Rules of thumb techniques: measure the payback period necessary to regain what was invested to acquire a property, and the methods needed to achieve the highest rate of return
 - Return on Investment (ROI)
 - Return on Equity (ROE)
 - Return on Asset (ROA)
 - Gross Income Multiplier (GIM)
 - Net Operating Multiplier (NIM)
 - Overall Capitalization Method (OCR)
- Discounted cash flow techniques: calculate the value today of the REI future cash flow. These take time value of money into consideration and include discounted payback period method, net present value method, internal rate of return and profitability index method
- Transitional valuation techniques: estimate the value of the property that will be used in the REI. These are cost approach, net income approach and market (sales) comparable approach

Step 5 – Investment decision

