

2.3.4 ADVANTAGES OF INVESTING IN REAL ESTATE

There are a number of reasons to invest in income-producing properties rather than in other conventional types of investments, but the main reasons are set out below.

To “Park” Your Capital. Do not squander it. For some investors, it is a benefit that real estate is not a liquid investment, that is, it is not easily converted back into cash. It forces the investor to be disciplined about the investment. Once you buy a property and sign a loan agreement (mortgage), you will do your utmost to make the scheduled payments, even if you have to keep your old car for a few more years or do without a European vacation.

— **To Be Protected Against Inflation.** Based on the Canadian Price Index (CPI), in Canada the average rate of inflation between 1914 and 2006 was 3.19% per year. Every time the cost of a square meter of land or of laying a new brick increases, every square meter of similar land or brick already increases in value too, although not necessarily in the same proportion. This concept disregards other factors, such as neighbourhood transitions and the economic obsolescence of buildings, but the simplistic implication is still that you generally benefit from price appreciation when you invest in real estate.

— **To Build-up Equity.** Assuming that you have made a wise investment, each time you collect a rental payment you will be building equity in your property by using your tenants’ rent to pay a portion of your mortgage.

— **The Ease of Refinancing.** Every time your Net Operating Income (NOI) increases markedly, through increased rentals or lowered expenses, you can arrange for a higher mortgage, freeing some of your initial equity. In other words, you will recover 100% of your equity in five to eight years; sometimes even sooner, with a little luck.

— **To Secure Positive Cash Flow.** This is the amount of money left after you subtract all operating and repair expenses, plus allowances for vacancies and bad debts, and mortgage payments, from the gross income. These regular monthly cheques are pretty nice.

— **To Increase your RSP Contributions.** Because rental income is considered by Canada Revenue Agency (CRA) as “earned income” for individuals, it can be used to increase the allowable amount of your Retirement Savings Plan (RSP) contributions and, thereby, defer the payment of taxes.

— **To Benefit from Income Tax Sheltering.** This is done through building depreciation (Capital Cost Allowance). In Canada, you may depreciate the building itself, not the land, at the rate of 4% (for most buildings) per year, on a declining balance.

— **To Benefit from Favourable Capital Gain Treatment.** If you sell the property, often you pay taxes on only 50% of your profits.

— **Insurance Premiums on Income Property Mortgages are Tax Deductible.** If you have an insured mortgage, in case circumstances are such that you cannot make the mortgage payments, the insurer will do so for you, but you will lose the equity you have in the property. You may deduct the premiums from the property income, so you are protected but pay with “before tax dollars.”

— **To Weather Economic Recessions.**

- Leases are relatively long term, the most common being five years.
- Staggered lease expirations are of benefit in smoothing out the impact of recessions.
- Real estate investments enjoy relatively longer market cycles compared to other kinds of investments.
- This is due to the fact that it takes years to erect new buildings, from concept to occupancy, passing through feasibility studies, architectural plans, financing, bids, construction and leasing.

- **Significant Future Demand.** There is the same amount of land but more and more people.
- **Greater Protection of Capital.** A prudent person would need to be consistently negligent to lose the capital he has invested in real estate.
- **Secure Higher Rates of Return.** Profits from ongoing operations, plus capital appreciation, plus leverage result in higher rates of return than most other investments.
- **Low Degree of Volatility.** Multiple tenants, staggered lease expirations dates, and long-term financing result in lower degrees of volatility.

2.3.5 DISADVANTAGES OF INVESTING IN REAL ESTATE

Since there is always two sides to any coin, you should consider the drawbacks of investing in real estate:

- It is not a liquid investment, as it usually takes months and, in some cases, years to sell a property.
- It requires relatively large amounts of money for the initial investment.
- There may be unexpected surprises (*from a cash flow viewpoint), such as a substantial tenant going bankrupt or a roof needing replacement at an inopportune time.
- It is “fixed”, that is, it cannot be moved.
- It requires management:
 - Of the asset (business and property management)
 - Of the money (bookkeeping, etc.), and
 - Of the tenants. In addition, dealing with tenants can be unpleasant, as landlords are not liked, as a rule.
- One is at the mercy of the governmental decisions: expropriation, new roads, new neighbors, new zoning, new taxes, rent controls, etc.
- The risk of financial loss, fortunately is rare, but it can happen due to several reasons:
 - Because the investor did not pay enough attention to the economy, in general, and to the real estate cycle, in particular, when making the decision to purchase the property,
 - The investor was too greedy; he took too much risk, or
 - It may be due to rotten luck. Some situations are difficult to anticipate: war, a good tenant going bankrupt, a down-turned market keeping the building empty a long time before a new tenant can be found, etc.
- Insufficient knowledge or lack of trustworthy professionals to advise you.

This excerpt has been taken from *Commercial Real Estate Investing in Canada: The Complete Reference for Real Estate Investors and Professionals*, © 2007 by Pierre and Claude Boiron. Published in 2007 by Wiley Canada.

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