# Time is right to buy an income property

## The rate of return on a new condo can be as high as 14.5%

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This spring, Janet and Brad Gilmore bought an executive condominium on the lake in Oakville as an investment for their retirement. The rent they charge on the condo pays for the mortgage and condo fees, they get a tax deduction for other associated costs of the unit and they get to write off depreciation.

"RRSPs seem to be going nowhere but down these days, but property always goes up," says Janet, a self-employed bookkeeper living in Oakville.

"It's certainly better than RRSPs," she says, "because it is quicker and you don't have to cash it in at 69. And you can keep the property in trust for the kids."

Buying rental property can make a lot of financial sense, if you can stand the headaches of being a landlord or can afford a property management company.

"If you do your research correctly, it is extraordinarily lucrative," says Brad Lamb, broker/owner of Brad J. Lamb Condominiums, a condo sales company in Toronto.

Will Dunning, a housing market consultant in Toronto, calculates that the likely return from buying, renting and eventually selling a new condo will fall between 12.5 per cent and 14.5 per cent.

Investing in a rental property in Toronto, whether it's a house, duplex, condo or small apartment building, is particularly enticing because of the minuscule vacancy rate in rental units. According to figures published by Canada Mortgage and Housing Corp. last year, Toronto has a 0.5 per cent vacancy rate, which means that only one out of 200 units is available. That means it's unlikely rents will be dropping any time soon.

Interest rates hovering near 40-year lows are another important reason that owning rental property is particularly attractive now. Five-year closed mortgages fell to as low as modest 5.65 per cent recently. Rents rise and, when the costs of owning a rental unit fall, the difference jumps into your pocket. (Landlords are allowed to raise rents 3.9 per cent next year for existing tenants and have no restrictions when pricing to a new tenant.)

Besides the low vacancy rate and low interest rates, there's the cost of property itself which, relative to incomes, is historically fairly affordable.

Peter Norman, vice-president of Clayton Research, a Toronto consulting firm of urban and real estate economists, says that in the 1980s, people were spending from 40 per cent to 50 per cent of their before-tax income on housing. Today, that figure is between 20 and 30 per cent.

In other words, a real estate purchase today isn't likely to fall in value even during a recession.

According to an October report by Royal LePage Real Estate Services Ltd., the average price of a two-storey home in Toronto increased 7.7 per cent to $312,059 from the same time last year. A bungalow rose 4 per cent to $293,333, and a condo climbed to $174,000 — an 8.7 per cent gain.

Norman feels prices might stay flat for 2002 due to a recession, but he predicts a 5 per cent to 6 per cent rise in housing prices in 2003.

"Over a long period of time, house prices keep up with wage inflation," he says. "And wage inflation is usually higher than price inflation."

Norman says small rental properties in the city have come up more rapidly than principal residences because the market for income properties is very strong. Even still, he says the cap rate on duplexes and 4- to 6-unit apartment buildings has moved below the target of 10 per cent. This, too, will put upward pressure on prices in the future. The cap rate is determined by dividing the property's net operating income by its capital cost. A cap rate of 10 or less is considered attractive for investment purposes.

So how do you know if a rental property is going to be a healthy cash machine? Brad Lamb has a simple rule of thumb: the cost of the property divided by its annual gross rent should be no more than 10.

He believes buying a condo unit before it is built, before the ground is even broken, offers the surest prospect of making a profit on the eventual sale of the condo. He also cautions people away from expensive neighbourhoods because the rent doesn't keep up with the purchase cost.

Lamb also advises his clients to buy small units because the rent per square foot is always higher on smaller units than on larger ones. "From 450 to 700 square feet is ideal," he says.

Will Dunning reminds investors that the mathematics of rental numbers is usually calculated on the eventual sale of the property. If you move into a property after renting it instead of selling it, the math stops working because converting a rental unit to a principal residence triggers unfavourable tax consequences.

The switch from rental to principal residence is treated for tax purposes as though you actually sold the property. You have to pay capital gains tax and recaptured depreciation without receiving the cash from an actual sale.

If you think the demographics favour a cottage as an investment instead of an urban rental property, think again.

Sherry Chris, vice-president of Network Services for Royal LePage in Toronto, says "in a recession, the first type of property to lose value is recreational." If you're still keen on country digs, she recommends looking for an excellent location, not one that is isolated or hard to get to.

To get the most rent for the fewest dollars invested in a residential rental, choose a unit with a contemporary floor plan and attractive finishings in an area of Toronto that is up and coming, but not yet hugely popular. Dunning says the numbers work best with the maximum mortgage and the longest amortization since this gives the most leverage on your own money.

Of course, no investment is without its cautions. Ron Nicksy, senior financial adviser and branch manager for Assante Capital Management in Etobicoke, believes individual investment properties expose people to too much un-diversified risk.

"Even if you put down only $10,000 on a $100,000 chunk of real estate, you still have a $100,000 exposure to not just one asset class, but one single property." Add that to your investment in your own home, and you could be making some big bets on the real estate sector.

Janet Gilmore warns prospective investors to look around for bargains. It took the Oakville couple six months to find their investment condo.

Arranged properly, rental property can generate monthly income and a robust capital gain when the property is eventually sold.

As Gilmore says, "It's great because somebody else is paying you for the property."