An alternative to condos

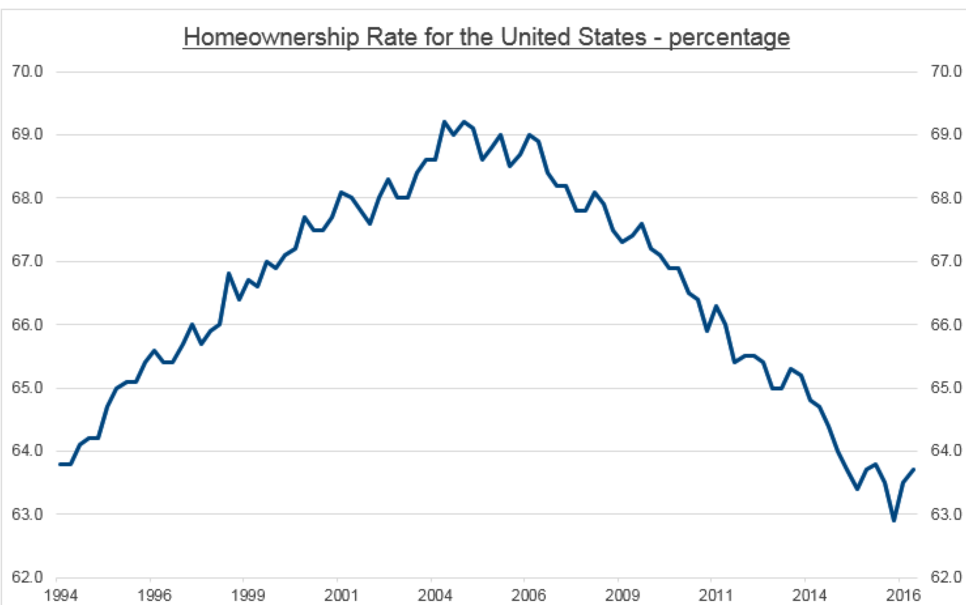
Hilliard MacBeth

Hilliard's Weekend Notebook – Friday March 24, 2017

In my 2015 book, "When the Bubble Bursts: Surviving the Canadian Real Estate Crash," I singled out the condominium as a rental property as a particularly bad idea. Recently, I had the chance to spend an hour with a top investment analyst, Jimmy Shan. He covers the real estate sector analyst for GMP Securities and he's done the calculations: condominiums are a terrible investment.

And he outlined an alternative — much better than condo ownership — for someone who is determined to invest in residential real estate as a landlord.

Let's review what we learned in the U.S. bubble and the crash. Many people were forced out of single family homes during the foreclosure phase and were pushed into rental accommodation. The proportion of homeownership dropped from 69 percent in 2005 to 63 percent in 2010 and hasn't recovered much since then.



Source: St. Louis Fed - FRED

Homeownership levels in Canada are very similar to the U.S. pre-crash; 69 percent in Canada and 71 percent in Ontario. But in the coming housing correction there will be many homeowners that move to rental accommodation, increasing the demand for rental units.

But direct ownership of a condo is not the best way to take advantage of that trend.

OUR PARTNERS

The MacBeth Group

Richardson GMP
10180 101 Street, Suite 3360
Edmonton, AB T5J 3S4

Tel. 1.780.409.7735
Fax 780.409.7777
www.TheMacBethGroup.com

Hilliard MacBeth
Director, Wealth Management
Portfolio Manager
Tel. 780.409.7740

The cost of owning a condo and the rent that can be earned make the returns very poor. Most condo owners that I've talked to are suffering a monthly loss, and that's before any "special assessments" or lawsuits.

The problem in the condo market is that rents are too low to cover the owner's costs. But in the apartment business, where purchase price and ownership costs are much lower and rents are more affordable, there is a good record of positive cash flow and great after-tax returns.

Most of us can't afford to buy an apartment building that would cost approximately $36 million for a 200-suiter at $180,000 per door. That's a market for institutional investors and very wealthy individuals. But there is another way to become an apartment owner; by purchasing shares in a Real Estate Investment Trust (REIT) that owns multiple apartment buildings.

Mr. Shan illustrated the difference between investing in a REIT and buying a condo directly. He compared a well-known Canadian REIT and a typical condo at Yonge and Eglington in Toronto. The REIT is Canadian Apartment Properties REIT, trading under the symbol CAR.UN on the S&P/TSX.

Other publicly-listed residential REITs are Boardwalk, InterRent, Mainstreet Equity, Killam Properties, Milestone, Morguard Residential, Northview and Pure Multi-Family.

Please note we are not recommending an investment in these securities. Our purpose is to compare a REIT investment to direct ownership of a condo.

Asset profile	Toronto Condo - Unit 2504, 30 Roehampton (Yonge/Eglington)	Canadian Apartment Properties (CAP) REIT - TSE: CAR.UN	
Purchase price [1]	$ 435,000	$ 186,000	
Land transfer taxes	$ 9,600	$ 10	
Legal & other closing costs	$ 1,500		
Total purchase price	$ 446,100	$ 186,010	
Square footage	503	750	
Total purchase price / sq. ft	**$ 887**	**$ 248**	70% cheaper...
Income profile			
Average monthly rent [2]	$ 1,700	$ 1,100	...but only 35% lower rent
Ancillary revenue		$ 85	
Gross revenue	$ 20,400	$ 15,454	
Vacancy rate	1.00%	1.00%	
Net revenue	$ 20,196	$ 15,300	
Property taxes [3]	$ (3,611)	$ (1,683)	
Condominium fees / utilities [3]	$ (3,444)	$ (1,530)	
Repairs and maintenance / op costs [3]	$ (500)	$ (2,754)	
Leasing commissions / op costs [3]	$ (1,700)		
Net rental income	**$ 10,942**	**$ 9,333**	
Return profile			
Unlevered return	2.5%	5.0%	Double the return
Risk profile			
Property management	Part-time	Professional; Active	Much lower risks
Concentration	High	Low - diversified	
Liquidity / Transaction costs	Low / High	High / Low	
Tenant	High	Low	

1) Condo is a listing at 30 Roehampton, unit 2504; CAP REIT price is based on implied price/suite
2) Condo rent is based on listing of similar size units; CAP REIT rent is average monthly rent as of Q3/16
3) Condo tax, fees are actuals, condo R&M is estimate based on $500/suite/year; Condo leasing commission assumes 1 month rent to leasing agent; CAP REIT operating costs based on 61% margin - achieved in 2016

Source: Jimmy Shan and Himanshu Gupta – GMP Securities

From a tenant point of view, the REIT units are 50 percent bigger, and 600 dollars per month cheaper to rent. The buildings are usually older and finishing details aren't as luxurious.

As an investor REITs are much safer and more convenient to manage. With a REIT there is diversification across many buildings in many locations. The condo owner is faced with building and location risk, not to mention the periodic hassle of finding a new tenant. As well, because of the REIT structure, there are tax advantages for the individual investor.

There is still investment risk in owning REITs as asset values and market trading values will fluctuate.

But for an investor the table demonstrates what I wrote in my book; owning a condo as an investment makes little sense when compared to alternative investments.

So if you're determined to become a landlord, have a look at investing in multi-family apartment REITs instead. You can contact us for more information about these securities and a copy of Jimmy Shan's report on REITs.

Hilliard MacBeth

Hilliard, The MacBeth Group team and their clients may trade in securities mentioned in this blog.