TURNER DRAKE + PARTNERS

newsletter

Vol. 2, No. 20 Spring 1986

Update

In 1978, we asked you for your suggestions for future articles. Keith R. Coles suggested a series of articles that would be of interest to the small investor. It appeared to us to be an excellent idea and from time to time we have dusted off his letter...and then hurriedly filed it away again as the wide scope of the subject became apparent.

At long last....after many hours of diligent research...we are proud to present for your reading pleasure...the Small Investor Series, Part One...

The Small Investor

Although this series is directed at the small investor...the person who invests in duplexes, triplexes, small apartment and commercial properties, the same principles apply to large investors too. However, in recognition of the fact that the small investor is, of necessity, a "do it yourself" type of person, this series of articles is designed to stress the **practical** aspects of real estate investing: which is not to suggest that we do not advise getting proper professional advice (us) when circumstances dictate.

Picking the Winners

The small investor has limited funds and virtually unlimited investment opportunities. His/her major problem is to screen out the wheat from the chaff: to establish which properties are worthy of close scrutiny and which can be discarded immediately. If this is not done then she/he will expend a considerable amount of time and effort on reviewing potential investments which do not meet his/her investment criteria.

For the purpose of this series, we are going to assume that the basic investor's objective is wealth maximization. Furthermore, we are going to assume that this is going to be achieved by directly investing in (i.e. purchasing) real estate. Since we are interested in wealth maximization, we will be focusing on maximizing the investor's after tax position.

Wealth Maximization

The small investor is going to receive a return on the money he/she invests in the property (equity investment) from two sources:

(1) The rent (the income stream).
(2) Capital growth in the value of the equity (the reversion).

newsletter is published by turner drake & partners ltd real estate consultants & appraisers
6182 north street halifax n.s. b3k 1p5 tel (902) 429-1811

Since the Federal Government has confounded the accounting profession by keeping its promise to bring in the capital gains tax exemption, the small investor can maximize his/her after tax wealth by shooting for a property that promises capital growth rather than immediate income. In other words, he/she would expect to take their profit out by selling the property sometime in the future, rather than through the rental income it produces.

We have to develop a decision rule which will allow the investor to pick the investment properties which promise the highest capital growth. Before we get into that, let's get our terminology straight...

Counting Your TOES

Let's start at the very beginning....

	Potential Gross Income	- this is the income you would get if the property was fully rented.
Less	Vacancy & Credit Loss	- this is the amount you would expect to lose each year due to vacancy and bad debts.
Equals	Effective Gross Income (EGI)	- usually the actual income for the last couple of years is a good guide.
Less	Total Operating Expenses (TOE)	- these comprise all the landlord's expenses, other than the mortgage payments.
Equals	Net Operating Income (NOI)	- you have to pay your mortgage payments out of this amount - the remainder is return on your equity.

Now we can calculate the Operating Expense Ratio i.e. $OER = \frac{TOE}{EGI}$

Our Decision Rule #1

The Operating Expense Ratio (OER) in conjunction with the expected growth in the Effective Gross Income (EGI) and the Total Operating Expense (TOE) can be used to predict whether the market value of the property will increase or decrease in the future.

The Market Value will:

Increase when $\frac{a}{b} > OER$

where: a = Expected growth in EGI
b = Expected growth in TOE

Remain unchanged when $\frac{a}{b} = OER$

Decrease when $\frac{a}{b} < OER$

Let's Put Rule #1 to Work....

Your friendly real estate broker has found the following apartment buildings for you. All are subject to rent controls which limit rental growth to 4% per annum and you don't expect they will be lifted in the foreseeable future, even though inflation is expected to increase operating expenses by 8% per annum.

You are in a high marginal tax bracket and are therefore primarily interested in capital growth. Rank them in descending order of anticipated capital growth, i.e. in preferred order of purchase:

Now: $\frac{a}{b} = \frac{4\%}{8\%} = 0.5$

Apartment Building	Effective Gross Income (EGI)	Total Operating Expenses (TOE)	Operating Expenses Ratio (OER)	Projected Change in Market Value	Ranking
A	$31,200	$15,300	0.49	Increase	2
B	$36,000	$19,100	0.53	Decrease	5
C	$40,000	$18,400	0.46	Increase	1
D	$27,000	$13,800	0.51	Decrease	4
E	$30,000	$15,000	0.50	Unchanged	3

Your first choice would be Building C and, if your pocket was deep enough, Building A.

Stayed tuned for the next episode in this exciting series....!

Nova Scotia

If you own or occupy a multi-use building in Nova Scotia, you will find that:

(1) If you are a Landlord - you will now be assessed for business occupancy tax on the common area i.e. parking lot, hallways, mall area, etc.

(2) If you are a Tenant - your business occupancy assessment will have been reduced from the 1985 figure.

This flows from the T. Eaton & Company assessment appeal (Newsletter Vol. 2, No. 18).

The matter is to be tested in Court again. However, we understand that notwithstanding this, legislation has been introduced to nullify the Eaton decision for 1987 and subsequent years.

I 'ears Yer 'an I Spits!

> "The workings of the great institutions are mainly the result of a mass of routine, petty malice, self-interest, carelessness, and sheer mistakes".
>
> ....Santayana

If, like us, you work in the private sector, you probably share our frustration and anger at the conspicuous waste practiced by all levels of government...how about this little gem....

Our offices are located in a renovated building on a major traffic artery. This year we decided to "do a number" on the landscaping in front of the building. Since the sidewalk was broken and decrepit and the City of Halifax had no money to fix it, we decided to be public spirited and spend a couple of thousand dollars replacing it for them. The City indicated they were in favour...provided we paid them $450. What for? Well...to provide for future maintenance. But, we patiently explained, that's what we **are** doing...if we don't provide a new sidewalk, the City will have to do it itself. True, they said...but them's the rules. Result...no new sidewalk from us...keep it up Halifax...one day you'll have a deficit to match the Fed's.