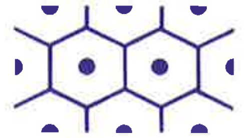
TURNER DRAKE + PARTNERS

newsletter



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Update

Halifax/Dartmouth

The chuckle of wavelets against the canoe, white clouds stealing across an azure sky, the whine of mosquitoes...aaah!...the sounds and sights of summer. The commercial real estate market is not relaxing though. In Dartmouth's Burnside Industrial Park, there is a flurry of removal vans as the oil industry pulls out for more hospitable climes. Falling oil prices and the collapse of offshore oil activity are persuading many firms to leave. Most of the offshore related companies were tenants rather than owners, so there is no evidence yet of large numbers of buildings for sale but some are coming on the market. Property owners with buildings rented to single offshore related tenants can be expected to place them on the market before the leases expire. Burnside has experienced healthy growth in property values over the past five years...look for one or two bargains over the next year or so.

On the other side of the harbour, Halifax's golden mile, Kempt Road, is experiencing remarkable resilience. Land values continue to escalate at **an average annual compound rate of 40%.** Inelastic supply faced with expanding demand continues to fuel a remarkable increase in property values that we thought had plateaued a year ago. The adjacent Robie Street area too is benefiting as commercial land is quickly snapped up. Canadian National will be placing their 10 acre Kempt Road site on the market later this year (so they say). They insist that it will be leased, rather than sold, and expect to call for proposals. Every man and his dog have registered an interest. Whilst we anticipate that this will alleviate the supply situation, leasing rather than selling may prove to be a less than exciting prospect to canny Maritimers who like to benefit from capital growth too.

...And talking of capital growth...there is a dearth of small commercial and industrial properties on the market. No doubt this is due to the Federal Government's action on the capital gains exemption. Imagine that...a government keeping an election promise...perhaps there is a Santa Claus after all!

Things are rolling along in Cole Harbour too. This year we have witnessed large increases in commercial land values...something we foresaw a couple of years ago...wonderful to be right...shame we didn't have the capital to cash in...still many are! This is a classic case of supply which is price inelastic. A similar situation pertains in Sackville folks...near the Downsview Mall. Roll on down and prove us right again!

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Things are not so shiny on the residential front though. The condo market is saturated in many areas...Brownie points to those clever clients who listened to us last year and built to rent instead of sell...black eyes to those who didn't; tut tut!

Single family homes in the $140,000 plus range are falling in value in some areas such as Eaglewood and Manor Park...are rising slowly in Clayton Park...whilst jolly old Peninsula South continues to log a steady 15% per annum compound increase. It's causing our residential appraisers some headaches so we have been burning the midnight oil revising our computer system. Our Neighbourhood Watch system now enables us to keep an eye on "rogue" neighbourhoods where property values move counter to general market trends. Presently under scrutiny are Clayton Park, Manor Park, Eaglewood, Colby Village (high priced homes) and Peninsula South. There are good buys in some of the first four areas for the stout hearted.

The Small Investor Series - Part Two

As we mentioned in Newsletter Volume 2, No. 20, this series is directed at the small investor...the person who invests in duplexes, triplexes, small apartment and commercial properties. However, the same principles apply to large investors too. Whilst the articles are designed to stress the practical aspects of real estate investing, we do advise getting proper professional advice when circumstances dictate.

Financing

Everybody is an expert on real estate...or so it appears to us. We suppose that doctors feel the same way about their profession...every one of their patients has a friend who is an expert in medicine. No doubt that's why so many doctors invest in real estate...perhaps we should try medicine...hmmm...anyway have you noticed how the mention of financing brings out the **real** experts? The trouble is...some opine that you should mortgage to the hilt...whilst others insist that "all cash" is the only way to go. Awkward really...put two experts together and they spawn three opinions. Let's take a purely non-expert look at the problem.

To Finance or Not to Finance; that is the Question!

Hold on to your hat...here we go.

Canny investors should borrow i.e. mortgage a property, even if they have enough money to buy the property outright **provided that** they will realize a gain from using OPM (other people's money). This is called **financial leverage.**

The financing decision involves two types of funds: debt (the mortgage) and equity (the cash the investor throws into the pot). Each of these sources have "prices" the investor must pay for their use. In making the financing decision, you have to compare the price of each source and decide whether or not to use the funds to make the investment.

The "price" attached to the use of the debt funds is simply the cost of borrowing the money on the mortgage.

The "price" attached to the use of the equity funds is the opportunity cost of those funds. In other words, it is the return you would get if you had invested those funds instead in an equally risky investment.

If the "price" of the mortgage debt is less than the "price" of the equity funds you should chose to borrow rather than invest your own money **whether you need to borrow or not!**

...And by borrowing you can spread your equity around and so purchase several investments rather then tying it all up in one or two projects. This is called "portfolio diversification" and will enable you to reduce the risk of losing your equity...but more of that in later issues of Newsletter.

Simple isn't it! Hang in there though...you haven't discovered the secret of eternal wealth yet.

...But as the mortgage debt increases, as a proportion of the property's market value, so does the risk to equity. In other words, the more you leverage the property, the more you increase the risk of getting no return on your equity.

Conditions for Favourable Leverage

You have to consider the impact of income tax when looking at leverage because the interest on the mortgage is deductable as an expense, provided the property produces income.

Positive Financial Leverage exists when the after-tax return on the investment **is greater than** the after-tax cost of borrowing because the after-tax return on equity will then **be greater than** the after-tax return on the overall investment.

Confused? Look, suppose you purchase a property for $100,000 from which you receive a net operating income of $12,000. Suppose you didn't pay any income tax at all: you would realize an overall after-tax (and before tax) return of 12% on the property. Provided that you could get a mortgage at less than 12% it would be worthwhile doing so (remember we are pretending you don't pay any tax). Since the cost of borrowing is less than the overall return, then the return you "save" on the cost of borrowing is "transferred" to the equity eg.

All Cash Purchase

$$\text{Return} = \frac{\text{NOI}}{\text{Market Value}}$$

$$\text{Return} = \frac{\$\ 12,000}{\$100,000}$$

Return = 12%

Leveraged Purchase (75% Mortgage @ 11%)

NOI		$12,000
Mortgage	$75,000	
Interest @ 11%	x 0.11	
	$ 8,250	$ 8,250
Return on Equity		$ 3,750
Equity Investment		÷$25,000
Return		15%

Of course, it is unlikely that you will pay no income tax so after-tax rates should be substituted in the above example. If you are addicted to formula this is a good conversation stopper:

$$\text{If } ra > Kd\,(1 - \tau)$$

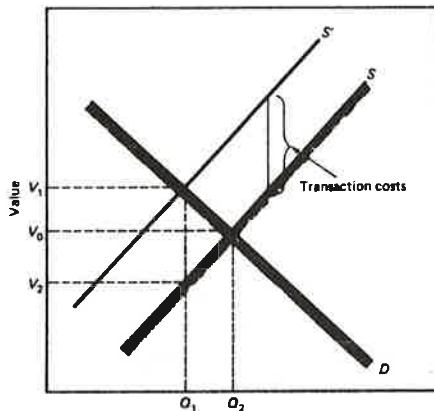
$$\text{then: } re > ra$$

where ra = expected after-tax return on the investment
Kd = expected pre-tax cost of borrowing
τ = marginal income tax rate
re = expected after-tax return on equity

Caveat Emptor

It has always struck us as odd that the vendor or lessor is represented by a real estate broker yet the purchaser or tenant has to fend for him/herself. We'd like to change all that...by representing purchasers and tenants. We have done a little research and find that there appears to be a groundswell in favour, particularly in Western Canada. We can tailor the contract with the purchaser or tenant so that there is a commonality of interest between the two of us in obtaining the most financially attractive price/rent. If you would like to blaze a few new trails, give Mike Turner a call at 902-429-1811 to discuss the matter.

Sales Commission.....Who Really Pays?



When it comes to sales commission, the vendor is convinced he really pays; after all he is the person who writes out the cheque to the real estate broker.

On the other hand, the purchaser too is convinced that he pays since the sales commission is a cost which the vendor adds to the price he wants for his property.

Who is right?

Actually both are correct; each pays part of the commission. Take a look at the graph above. The line "S" represents the supply curve for the real estate; the line "D" the demand for it. If there are no transaction costs (commission), then Q_2 amount of the property will be sold at price V_o. If there is a transaction cost then there will be a perceived reduction in the supply of the real estate by the consumer, resulting in a shift of the supply curve to "S^1". This in turn results in a new and higher equilibrium price V_1. Since the difference between the new price V_1 and the old price V_o is less than the transaction cost only part of the commission is being absorbed by the purchase. The balance is paid by the vendor. The less price elastic the supply (i.e. the scarcer the real estate) the smaller the portion of the commission that will be "paid" by the purchaser.

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