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Safe as houses? Not always

Investing in real estate may seem solid, but there are plenty of pitfalls

›BY ARTHUR SALZER

IT'S HARD TO BELIEVE, but it is 29 years since I became a realtor after completing summer school in Orillia, Ont., and before I entered university. I remember many lessons from the class, but one of the things I don't think I heard at the time was how overheated the real estate market was: 1988 marked the peak of the Ontario market and prices headed south over the next five years to bottom in 1993. Government-induced higher interest rates were to blame back then.

Spending my first few years out of school as a real estate analyst for my family and then as a residential lender for one of the Canadian banks was formative. My job at the bank involved calling borrowers into my branch to review their financial situation, and then typically having to say that their line of credit was being reduced or, worse, termed out. Either way, it placed significant cash-flow and financial strain on these individuals. I felt for them and the repercussions on their family, but the bank simply viewed it as reducing portfolio risk.

This past decade, a significant proportion of the money going into condo development in Canada is coming through syndicates designed to raise money from wealthy investors — some of it equity, but much of it debt. Debt is the prime ingredient that gives real estate investing its boost, since unleveraged real estate over the long term has underperformed other asset classes such as stocks and bonds. The attractiveness of real estate to an investor grows or diminishes with the availability and cost of debt. If capital markets restrict the supply of leverage, the price of real estate drops since development and purchases require greater amounts of high-cost equity.

These wealthy investors typically hold money within a holding company, which generally is a tier above an operating company. There is another name for these wealthy investors: family businesses owners or family enterprise, the very same group that Minister of Finance Bill Morneau and Justin Trudeau say are holding "dead money." It's this dead money that funds developments that generate high-paying employment and significant taxes all through the building process and then even after through municipal taxes. This capital doesn't sound dead to me, but it can at the sound-bite level. Scratch the surface of the potential changes to taxing family businesses and one begins to see the potential catastrophic damage these changes would bring to all Canadians.

Still, despite the potential risks in primary markets such as Toronto and Vancouver, which have been highlighted in a recent UBS real estate study as the riskiest and fourth-riskiest residential markets in the world, investing in real estate can still have its benefits. Private real estate is where this asset class gathers much attention as it has the ability to become a portfolio diversifier and provide higher potential reward, but at the cost of greater risk and reduced liquidity.

Given that many high-net-worth investors like owning things that they can see and touch, direct investing in real estate through the purchase of a single property provides the greatest control, and appeal, but also the highest level of risk. Investing successfully in this area requires hands-on operating abilities combined with knowledge of the local marketplace, as well as the desire and financial wherewithal to sign personal guarantees to lenders in order to finance property ownership.

But if an investor does not wish to put up a personal guarantee or does not have the ability to buy, operate and sell property, private partnerships or funds are available to those who have moderate to high levels of capital. Private funds may be open (like a mutual fund) or close-ended, with liquidity being as short as 30 days or longer than 10 years. The objective of these funds is to pool the capital of multiple investors, which is then managed by a general partner (GP) who tends to have extensive experience in owning and operating real estate and is willing to put up a personal guarantee to the lenders. This means that partnership investors usually have limited liability, hence they are often called LPs. Private funds invest in many real estate sectors, ranging from specific areas such as residential mortgages, construction loans and hotels to broad and well-diversified portfolios across the globe, depending on the capabilities and experience of the GP.

> " The world of private funds is complex and more expensive than mutual funds

If you think the fees in a mutual fund are hard to determine or are excessive, the world of private funds is much more complex and expensive. Typically, the general partner receives an ongoing fee for managing the fund along with a slice of the shared profits, which disproportionately go in the favour of the GP, even though the LPs put up the majority of the capital for a fund. The typical ratio is that 20% of the profits go to the GP after the investors receive their initial capital back along with a preferred rate of return, usually in the 7%-10% range.

Recently, during conversations with my former real estate teacher, a dear friend and mentor who still operates as an estate appraiser in Central Ontario, we've spoken of the excessive valuations and lack of affordability across many real estate sectors. What pops the bubble this time? We are not sure. In any regard, the term caveat emptor – let the buyer beware — was the first term I learned in my real estate classes. **FPM**

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