The Easy Way to Create a Real Estate Empire (and Never Fix a Toilet Again!)

Description

Many Canadians are attracted to the world of real estate.

There are countless stories of savvy investors who, after a few decades of hard work, now live on the rent generated by a nice portfolio of investment properties. These investors have ridden the bull market in virtually every Canadian market to handsome price gains as well.

Many investors who want to duplicate this path to wealth are out buying rental properties as we speak. But unfortunately, it's unlikely they'll see the level of success as the last generation did. Cap rates are much lower than before–a consequence of low interest rates–and it's unlikely they'll see the kind of capital appreciation enjoyed by their parents.

There's a better solution. It offers the potential for better returns going forward, and investors don't have to worry about any of the day-to-day operations.

Leverage REITs

You can probably tell where I'm going with this. I'm convinced Canada's largest REITs are a better choice than a traditional rental property for many reasons. Often, the distributions are taxed at a better rate than straight rent received from a rental property. You get the benefit of professional management at a great price because of economies of scale. And REITs give retail investors access to areas of the market they normally wouldn't be able to participate in, like commercial or industrial property.

There's one advantage to buying physical rental property over REITs though, and that's the ability to leverage. It's possible–although usually not recommended–for an investor to purchase a rental for just 5% down. That kind of debt can lead to a succulent return on the original invested capital if done right, but it also adds significant risk. If underlying property values fall 5%, it would represent a 100% loss on the original investment.

It's for this reason why most real estate investors put down 20%. That amount allows them to avoid expensive mortgage default insurance, and it builds in a little margin of safety. It's still enough leverage that investors can capture the positive aspects of borrowing as well.

Investors can use leverage to buy REITs, and pretty easily, too. Most Canadian REITs are eligible for what brokers call reduced margin, which means you only have to maintain 30% of the stock price as equity in your account.

An investor could then supplement that by borrowing outside of their account. Say you had $50,000 in cash and the ability to borrow another $50,000 via a home equity line of credit for 3% annually. You could then take that $100,000 and easily use it to buy $200,000 worth of REITs. At a 50% debt-to-equity ratio, you wouldn't have to worry so much about margin calls either. And depending on your broker, the cost to borrow could be as low as prime.

Of course, there's a big risk factor. If the value of the underlying REITs falls significantly, you'll either be forced to come up with more cash or sell at a loss.

An example

Let's look at a real-life example of how an investor could do this using two of Canada's largest REITs, **H&R Real Estate Investment Trust** (TSX:HR.UN) and **RioCan Real Estate Investment Trust** (TSX:REI.UN). H&R yields 6.9%, while RioCan pays 5.6%. Assuming equal amounts of the two, an investor would be looking at a 6.25% yield.

On a $200,000 investment (with $150,000 borrowed at an average rate of 3%), an investor would collect $12,500 per year in dividends, while paying out $4,500 in interest. Unlike with physical real estate, there are no other expenses. Gross profit would be $7,000, while net profit would be $7,000 minus taxes.

That's a very attractive 14% return on the original $50,000 investment.

I picked H&R and RioCan because they're two of the more solid REITs out there. Both have good management teams, diverse portfolios, reasonable balance sheets, and attractive payout ratios. If an investor wanted to take on more risk, there are others out there that could easily bump the total yield for the portfolio up to 8%.

And the best part? If you buy REITs, you'll never have to fix a toilet again. Nice potential returns with no work? Sounds good to me.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

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2. TSX:REI.UN (RioCan Real Estate Investment Trust)

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