The Just Word Podcast

Transcript of Episode 34: Real Estate as an Investment

Guest: Alex Leduc

Pat Bolland 00:00
Alex, a real pleasure to meet you. I've always been interested in real estate as an investment. But as I say, most of the time people think about a roof over their heads, or at least making the next payment, you took a different approach ... a digital approach. Explain that.

Alex Leduc 00:19
Yeah, absolutely. And thanks for having me, Pat. It's a pleasure to be on your show here. So yeah, you know what, actually funny enough, a lot of people view real estate as not their investment, usually on the first one. But after you get your first property, there's usually a big shift, once people kind of get a sense for, hey, this is a pretty good return, like net of everything. So we took an approach to it from a digital standpoint to help people buy their first home, but then also help a homeowners build wealth. And typically what that means for a lot of people is then also building out a rental property and portfolio. So the benefit of doing it digitally is a lot of the oversight that comes with it. Because if you've got one property, it's usually pretty easy to stay on top of it. But if you've got three, four, maybe even five, let's say plus properties, to monitor when mortgage rates change how much equity you have in your home, all these things become very different, or difficult to keep up with. So if we have a system, which essentially is what purge does for our clients is that we're automatically notifying them when there's essentially opportunities for them to maximize wealth on an individual property level, and then helping them keep up with, you know, how is my portfolio doing from a rental standpoint?

Pat Bolland 01:23
And I'll get into the follow up, if you will, once things are up and running with Perch. But what's the biggest challenge initially, for people to get into real estate as an investment?

Alex Leduc 01:35
Well, with house prices nowadays, I think it's just the downpayment strictly is a pretty big obstacle. So when you buy your first home, it's 5%, on the first 500, 10% on anything above that, so let's just say at the highest price point, if you're buying 999,999, you'd be putting down roughly seven and a half percent, which is roughly $75,000. However, if you're buying a rental property, the minimum downpayment is typically 20%. So even if you're buying an $800,000, home, that's $160,000, in equity that you need to have saved up. So just looking at how most real estate investors, a lot of them use their existing home equity as leverage to get into the next one. So if I've got, you know, property with $100,000 of equity in it, I've already paid for most of my next downpayment through my existing home. But if you're getting your first one, you essentially have no home equity to leverage and it's purely based on whatever you can put together.

Pat Bolland 02:26

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You mentioned an interesting word there, leverage, I mean, real estate prices, universally, almost certainly across Canada, and certainly in Toronto, for instance, have done nothing for the last decade, but go straight up, but you're talking about leverage upon leverage. So you got to hope that real estate continues to go up. What are your thoughts on that?

Alex Leduc 02:46
Yeah, so it's, it's always the, I guess, the double edged sword of leveraged returns, right? It's always really good if it's on the way up, but then it essentially amplifies anything, whether it's up or downwards. I mean, personally, I think there's a lot of protections in place that help somebody who is leveraging a real estate portfolio, be able to salvage it. So for example, most people don't fully leverage everything they have. So they try to keep like a reasonable mix of loan to value. Because a lot of real estate investors typically look at cash flow. And it's hard to get something to cashflow. If you're constantly maxing out the amount on your mortgage. So there's things like, you know, higher amortizations, etc, that can help you keep the mortgage payments lower. So it reduces the ability for you to actually like fall into any financial difficulties. And compounded with low vacancy rates, it's pretty reasonable for you to kind of keep that cash flow going. So if you've got a longer term horizon, the likelihood that you ended up selling your property at a loss is a lot lower, because right now, I don't think anybody expects that next year, you know, we'll get 20-30% HPI gains like we did this year. But it's not unreasonable to assume over a 5-10 year time horizon that you probably should still realize some some price appreciation on your property. And then things like re-amortizing your loan. So it's really just a matter of how you can make it cash flow through difficult times to make sure that so it's very similar to stocks, like if you're forced to sell at a bad time, you're gonna have a higher likelihood of losses. So just making sure we'll invest real estate investors are able to ride through the ups and downs to kind of make it out on the other side.

Pat Bolland 04:15
OK so all I'm hearing is that this is a long term investment. And something maybe you should look at for retirement, say 10,20,30 years down the road if you're of that particular age group. When is it too late, though, to get into the game?

Alex Leduc 04:31
So I'm actually really glad you brought that one up, because it really isn't a matter of how late is too late. Because up until the moment you retire, you have qualifying income. So a lot of people think that you know, I can't get a mortgage when I'm 60 or 65, or whatever the number is, the reality is you actually still can. So for especially if you're going into retirement, retirement will depending on how active you want to be as a property manager, you have to be realistic about maybe you hire a property manager and you just get the benefit of the passive income, it's actually a great retirement strategy for a lot of people. Because if you're holding the properties for a certain amount of time, you typically are paying down your mortgage, rents keep increasing over time, and then you're able to get positive cash flow that just keeps increasing over time. And then eventually you pay your mortgage off. And then you're basically just clearing the entire rent payment minus the you know, the maintenance, property taxes, etc, whatever it is that you're paying. So as a retired person like that passive income is actually really, really beneficial, since you're getting it on a monthly distribution as well, which typically lines up with your spending power. So I'd say where it's harder to get in is when you're actually retired, you've

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lost your qualifying income or not lost, but you no longer are working, so you don't have your qualifying income anymore, your ability to leverage your properties is significantly reduced. Because essentially, you'll start with, let's say, the pecking order of financing. So you'll go to an A lender or prime lender and try to get the best possible financing rates out there. But if you don't qualify, you then go to an alternative lender, or some people refer to as a B-lender and see how much you can get there. And then if nothing works at the lender, you then go private, but it's economics on a private mortgage typically don't make it very economical for you to get a return. So it's typically on the A or the B side that you want to stick to as a rental property owner.

Pat Bolland 06:12
I get what you're saying, I just don't know, as somebody close to retirement myself, whether I want to have that leverage through retirement, you know, what I'm saying? I'd rather have everything free and clear for kids and passing it on to kids. Do you run into that a lot.

Alex Leduc 06:28
So it is a very common scenario where even like the moment people like before retirement, let's say if you had your mortgage and your 30s, or 40s, that a lot of people are very driven to like, I'm gonna pay my mortgage down at zero, I want to own my property free and clear. Like that's actually almost like a mental goal that people have in mind. But what we're seeing more and more, that's a big issue is when people go into retirement, their only asset is their homes. So the or the bulk of their assets, I should say. So like, let's say, you know, your TFSA is RSP is a lot of contribution room that wasn't used. The issue with that is when you go into retirement, like I just talked about, you lost your qualifying income. So before retirement, you would have been able to leverage your home, diversify your portfolio, to have a mix of liquid and what would arguably be an illiquid asset, which is your house. Because in retirement, you're going to need to draw down on your assets, you're going to fund your retirement essentially. But when your house is your only asset, what people end up having to do is do reverse mortgages, private mortgages, home equity lines of credit other ways to essentially access their home equity, that are typically much more expensive than if you would have just done it as a regular mortgage payment. So the benefit to you as a homeowner is if you're able to leverage your home while you still have the opportunity. It enables you to use it during retirement versus being stuck with a limited or more limited option range when in retirement if you don't have other assets.

Pat Bolland 07:45
Interesting. You mentioned earlier, and you touched on it a little bit qualifying ratios, you know, when you walk into your initial mortgage lender, if you will. And there must be a pre-approval process that makes that a lot easier than walking into a stranger and saying, Hey, I'd like some money.

Alex Leduc 08:03
No, absolutely. And it's and this actually like, sometimes is a huge shock to people because they almost kind of just bank on the fact that I've got a million dollar property. Of course, I can take money out like you know what I mean? Like, what's the risk to the bank, right, unfortunately, like a lot of the time, so let's say somebody who's nearing retirement, if they have their house free and clear, the last time they applied for a mortgage was probably 15 or 20 years ago. So the amount of changes on a regulatory standpoint, documentation, just all of the above that have occurred since then, are a lot of

the times a huge shock to these people, when they're like, oh my god, I can't get any money from on my house. So when you go in for a pre approval, which is something that we help our buyers do, typically it's less than 20 minutes, we're literally underwriting you the same way the bank would look at you. So we do it because we have access to about 30 lenders. So we're pre approving you to see where you'd qualify how much you qualify and what your terms would be. So this is where we have the conversation of, okay, based on where you're at, here's what you can do with A lender, an alternative lender or reverse mortgage, etc. Here's what we recommend. But it's always good to get that advice, while you still have all the options at your disposal versus like, well, I can't really get you here anymore. This is kind of on your own your only option based on where you're at.

Pat Bolland 09:14
Okay, so what happens then, for instance, and I know the rules have changed in terms of the pre approval, and it used to be that you had the they did pre approval based on 5% and you had to ... or five years, I can't remember exactly what the numbers are, have they made it considerably more difficult then for pre approval.

Alex Leduc 09:32
So where there's the biggest shocks, especially as if someone's on, let's say self employed or anything like that. So the standard pre approval process is three things. So what is your qualifying income? What are your qualifying assets? And what's your credit? So typically credit for somebody who's has a mortgage free and clear, like very rarely would I come across somebody who, you know, assuming they haven't gone through anything crazy. They typically have the credit score they need to get the financing. From an asset standpoint, the scenario I was referring to earlier is pretty common. Actually. You'd surprised and a lot of people have maybe a free and clear property that's appreciated wildly in 20-30 years. So they have a high net worth, but they don't have anything outside of their home, that they can really kind of show other than the property. And then from an income standpoint, by the time you retired, it'll either be a pension income that you're receiving. So these will be what counts as qualifying income. So but when you were working, we could have used, let's say, your base salary, your bonus. If you're self employed, it will be based on what's on your T1. So what you're actually paying yourself from your corporation, not what your business makes, typically. And then things like pension income, etc. So it's not the fact that that might have been what you would have had to provide back then as documentation. It's more just in regards to how much leverage someone's willing to give you. So you know, back in the day, there was a lot of equity lending, that banks would go ... yup, if you have this much equity in your home will lend against it. Today, it's not really as common, you have to qualify for a certain amount, equity does get factored into that component. So if you're doing like 50% of the value of your home, that's a lot less risky to the bank and an 80% loan, but you still need income and some kind of qualifying income to be able to service it. And this is what catches most people off guard, because if you have no company pension, and then you're really like relying on let's say, CPP OAS and maybe a bit of assets that you were going to start drawing down, that means you effectively have no qualifying income outside of your pension. So that's where the difference really kind of hits you harder.

Pat Bolland 11:23

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Okay, I'm going to walk through some of the challenges, though, of getting into this game. And I'm going to start off with interest rates, because we're right on the cusp of potentially of interest rates going up significantly, for instance, what does that do to mortgage rates? What does it do to your leverage? Those are the first two questions. And then the third one, what are your thoughts on interest rates? How high could they go?

Alex Leduc 11:42
Yeah, so the first question in regards to actually, I guess, what was the difference from your first and your third question, then, because I think your first one was, where interest rates are now and how high they're gonna go is that

Pat Bolland 11:52
all three are kind of like that. But you know, it's interest rates, and then mortgage rates as well. And then interest rates.

Alex Leduc 11:59
Got it. So I guess to for For context, then so most, I'd say it's about 70% of people in Canada, like roughly give or take 10%, usually go for a fixed mortgage over a variable one. So the vast majority are typically also in five year terms. So let's just say five year fixed arguably is the most popular term in Canada that people sign up for. So where we're seeing a lot of movements today, so what influences a five year fixed mortgage is typically the Government of Canada bond yields. So when you have thing there's, and this is a macro economic influence. So whenever you have a higher inflation expectations, higher GDP, like it's related to all of the positive economic momentum that people are expecting, typically, you then have raising interest rates, because you need to kind of, you know, keep inflation in check. So with those higher expectations, we've seen government bond yields jump in the last two, three weeks alone, where I think we're closer to like two and a half percent, just for context, like I think we were at like one and a half percent about a month ago. So it's been like a lot of it has happened really quickly. So what that means is, as bond yields go up, we've seen banks essentially increase their their mortgage rates in tandem. So what that translates to is higher mortgage rates for the consumer. But the benefit is a lot of these rates changes have been in the relatively in the short term. So really, if you're getting a new mortgage rate, then yes, it does mean that you're looking at a more expensive cost of financing. So on the average mortgage, it might translate to about, I think it's maybe a couple 100 bucks a month on your mortgage payment for every let's call it 1% increase in your mortgage rate. In regards to how much higher do I think they're gonna go? Quite frankly, I think we've already ... I don't see it going much higher than where they already are today. Like, let's say maybe like another quarter point at the most. Because I mean, arguably, rates are already a lot higher today than they were even a couple months ago. Today, I think you're looking at low to mid threes for a five year fixed mortgage. So I think it's amidst a ton of political uncertainty, a lot of macro economic events that are kind of hyperinflation, not hyperinflation, but fast increasing inflation. So I don't think there's a lot more upside in regards to how much higher interest rates can go. And if anything, once it kind of stabilizes, and things, once we take the risk premium out of the market, let's call it when things kind of normalize, I think you'll start to maybe even see them come back down a little bit. But not in .. Yeah, so I'd say let's say within a 25% or 25 basis point ban, that's probably where rates will stick around for the next let's call it six months, I think. But I think what happens then is then you have prime rate increases. So if

people didn't go fix, then you've got your variable rate. So Prime, we had our first increase last, I think it was earlier this month or last month, I can't remember the exact date. But the Bank of Canada did their first quarter point increase for a very long time. And now there's speculation that in their next meeting, they might even do another half point increase. So we actually have like, we have a Pathfinder tool on Perch that actually is able to take expected prime rate increases, and we're able to compare fixed, variable, renewal differences, all these things to help you decide which one's the best current price rate. So what we saw, even for the last couple of months is we were expecting eight prime rate increase. So eight, meaning a 2% increase in the prime rate over the next two, three years. I think that's a very ambitious number of increases like eight would be tremendous. Like, first of all, like, that's a lot of just historically, in such a short window of time, I think I think there's gonna be at least four, I don't think there's going to be eight. But what happens though, is we had a massive spread between our fixed or variable. So even just to take one or two months ago, you were able to get a 1% five year variable rate, and then your fixed equivalent would be maybe about two, two and a half percent. So just the fact that there was such a sheer gap in those amounts, there naturally had to be a bit of a gap closing there. So for for everybody getting a new mortgage, I'd say right now is probably near the peak of where you should expect fixed rates to be maybe another quarter point, but it's not a material difference, like at the end of the day for monthly payments. But where it affects people less is for people who have an existing mortgage, if you have a variable rate, I mean, assuming like, you should have had some kind of baseline assumption that my rate won't stay at 1% forever. So you're already kind of expecting it to hit at least two, maybe two and a half. So this is more or less kind of just getting you on trajectory with where you thought you'd be. And then for anybody who has an existing fixed rate mortgage, if you're you're really not going to be affected until you renew. So that's, you know, if anybody who got it three, four months ago, fantastic, you don't have to worry about this for another four or five years. But then if it's anybody who got their fixed rate mortgage four years ago, that's coming up for renewal now, it's not actually as big of a rate difference from four years ago to where we are today, versus the person who got it like a year ago, which was arguably the lowest rates had ever been. So I think, you know, if you come up for renewal, you shouldn't expect that your rate would be lower than what it was when you first got it. So shopping around, make sure obviously, that doesn't mean you shouldn't still be scrutinizing how good the deal is. But there is an expectation that you will be getting market rates, which unfortunately might have gone up since you last looked at it.

Pat Bolland 17:09
Okay, so that's check the box for interest rates. The other big challenge is, if you do get into the rental business, you have to deal with tenants.

Alex Leduc 17:19
Yes, that is the that is the big Asterix there.

Pat Bolland 17:24
Yeah. So I've I've got three, four or five properties that I'm potentially renting. How do I deal with tenants?

Alex Leduc 17:33

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So the first question, and usually you'll go over this with your realtor, if you're working with one at the beginning, is it's usually do I want to deal with tenants? It's just like the first question you should ask yourself, because it's not like you actually have to, you can hire property managers or delegate that component of it. If it's like, I want to be a bit more passive. I don't feel like responding to you know, repair inquiries, finding the right people, servicers, contractors, etc, to kind of deal with my property. So there are property like, you know, like the white glove approach, where I just want to collect my rental income, I want to make my return. And then I'm going to sacrifice a bit of that rental income, obviously, because there is a cost to property management. So those this is more of just like, do you have the time and the skills to be a landlord, because obviously, to your point, if you've got three, four rentals, like that's, that's not an insignificant amount of time, you're gonna have to commit, especially if it let's say, if it's a detached home versus a condo, there's gonna be a lot more maintenance, you're gonna have to do on the detached home because there's no there is no property management, there is no condo Corp that's essentially doing pre scheduled maintenance and things like that. So then, if you decide you do want to deal with the tenants, the biggest question is then screening them, like how do you actually effectively screen tenants because some tenants will be a lot more of a headache than others. So like any landlord who's been doing this a long time will always tell you that the relationship with the tenant is also super important. Because if you're good to them, they'll for most cases also be good to you. Like no one's really actively looking to sabotage your, your property holdings here. So yeah, so just not it's a matter of if you're not overly focused on just purely the financial component of it, like you do have people living there. And they have their problems, they have their obligations, they have their financial situation. And so just being a bit more open to and having those conversations and being a bit more respectful to each other, I think typically is what ended up being good versus being super nitpicky, like enforcing the rent increases as soon as humanly possible and being overly focused on it then typically can build a bit of a bad relationship and then when you need them to help you because arguably, there's a lot of things that especially for first time landlords that you need to learn about is that the law is very much in the favor of the tenant. So if you want to evict someone if you don't do if you want to realist, release, whatever it is, like it's not actually as easy as just simply telling someone like, Hey, you have to leave now. There's a ton of regulation. Yeah.

Pat Bolland 19:57
So that's, that's interest rates. So that's the financial risk of tenant-risk address. Everybody, as always said real estate's about location, location, location. What are your thoughts on? What's a good place to look these days?

Alex Leduc 20:14
Oh, man, it's. So it's been interesting, actually, during COVID, because there's been a breakdown between let's call it location and vocation. So normally, you'd look for those areas that are like really hot, like, like one of the common criteria would be the economic growth and the immediate surrounding environment where you're buying a property. But now I've been seeing a lot of people buying properties that are actually more of like from an affordability standpoint, because you have more and more people working remotely. So you're able to find these developments that are maybe not as important from a location standpoint, but the economics are fantastic. Because if you're able to get a lower price point, but charge a higher rent, it becomes something that's more feasible, because a lot more people are actually now able to go live there. Even if previously you had a limited it was, you know, way back, let's

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call it like real estate in the early days it was ... I have homes near where people work. And then if I have a lot of jobs being created that should result in more people looking for homes. That's still holds true, but it's not as elastic, let's call it of a reaction where if I have homes in an area that's affordable, relatively close to where people work, or has, you know, like beautiful scenery, I'm thinking places like Kelowna, for example, is a really hot housing market, but arguably, is not a city with an insane amount of job opportunity. It's where it's like, you know what I mean? Like, it's not like a Toronto or Vancouver or anything like that, where there's jobs every day getting listed. But it's one of the hottest housing markets in the country. Same thing with Prince Edward Island, Nova Scotia, all these other provinces. So you're seeing a lot more people and even some of our clients, I have people doing parallel searches where that's I want to live in Kitchener, ideally. But I'll also go to Calgary. So it's becoming interesting, when you have that dynamic in the market, it then becomes possible for you to do it, where you can buy an investment property, get people that would be remote workers living there, even if it's not necessarily the best possible location. But what also we're seeing is vacancy rates in more rural areas are also extremely low. So what ends up happening is people who rent end up paying much like very like very, very high rents, because there's limited supply. So it's also then the which also factors into your equation as a as a rental property owner is what's the vacancy rates? Like? How, how much demand would there be for my property if I bought it there? So that also is kind of a factor where the location? Yeah, I guess it's more than just where the jobs are. It's where the vacancy rates are, where people are migrating, where there is a economic center or some kind of reason to live there. So now I'm looking at things with a real rental investor, some of the criteria they're looking at now is, how close is this to like accessible transit where I could get to, let's say, so just use an example. If I have to work remotely, and maybe it's a hybrid, I have to commute once a day. I could live in Kitchener and work in Toronto, because I haven't like if I have to make a two hour commute or one and a half hour, one and a half hour at once a week. Not so bad. At that point, even London, Ontario could actually work. Niagara could work. So those are areas before that, if you had the full five day work week office, like you couldn't live outside of a much more limited window.

Pat Bolland 23:18
Things have changed Alex, no question. A great pleasure to talk to you.

Alex Leduc 23:22
Absolutely. And I really appreciate your time. Really great questions. And yeah, hopefully, rental investors out there. Take a look because it's delivered a phenomenal return for like, when you actually look past the leverage of like, what's your actual ROI? rental properties have been killing it? For a lot of people.

Pat Bolland 23:40
Yeah, we'll see. Alex, thanks so much.

Alex Leduc 23:43
Yeah, thank you Pat. Have a great day.

Pat Bolland 23:45

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You too. Alex Leduc, co founder of Perch, a Toronto based real estate tech startup, I guess you would call it

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