

11.1 LEVERAGING

Few people but real estate without borrowing against it. The process is called “leverage”. Leverage is using borrowed funds for an investment with the expectations that the profits from the investment will be greater than the interest payable. In real estate, leveraging can substantially increase your return on equity (ROE). As long as the Cap Rate (Net Operating Income (NOTI)/Market Value) is higher than the mortgage constant factor, the leverage is positive. Leverage is negative when the Cap Rate is lower than the constant mortgage factor (see section 11.4.2)

Let’s look again at the example given in Chapter 2 (section 2.5.2) that illustrated the impact of leveraging. In that example a property is purchased for \$1 million and the cap Rate (return before financing) is 10% or \$100,000.

Option 1

The purchase price is \$1,000,000, and you pay cash.

Your direct return is 10% (\$1,000,000 x .10):	\$100,000
Plus appreciation of 6% (\$1,000,000 x .06):	\$60,000
Total return:	\$160,000
Total annual rate of return on your equity (\$160,000/\$1,000,000):	0.16 or 16%

Option 2

You pay \$400,000 cash and borrow 60% of the purchase price (\$600,000) at 7% interest, paying \$42,000 per year, interest only.

Your direct return is (\$100,000 - \$42,000):	\$58,000
Rate of return (\$58,000/\$400,000):	14.50% return
Plus appreciation (indirect return) of 6% (\$1,000,000 x .06):	\$60,000
Total return (direct return + appreciation):	\$118,000
Total rate of return (\$118,000/\$400,000)	0.295 or 29.50%

At the bottom of the real estate cycle, you can borrow up to 80% of a property’s value (known at the “loan-to-value” or LTV ration) with limited risks, in some cases. At the top of the cycle, when it looks like prices may be peaking or due to decline, 50% is the maximum you should borrow to control risk. Another primary consideration is the quality of the tenant(s).

This is in theory, of course. In real life, many budding investors with limited cash will take chances borrowing as much as they can and hope that nothing will go wrong. Thanks to appreciation, most succeed. Note that under the law, banks are not permitted to provide financing in an amount greater than 75% of the value of the property, or of the purchase price, unless the mortgage is insured (see section 11.9).

Financing a property at 100% should be done with extreme care. In principle, you would go this route only when one of the two following situations exists:

1. When buying a building that is in bad shape or poorly leased, but you know that by spending some money and time, you will markedly increase the income from what it is today; or
2. When the tenant on the property is a no-risk tenant due to its financial strength, such as IBM or the federal government.

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