

## Summer Home

Aug 2007

My wife and I were driving up to Penticton the other day for her Grad Reunion. I love the Okanagan but have lived virtually all of my life in Vancouver. My wife, needless to say, being an Okanagan gal, often finds herself pining for the sun drenched days of her childhood on the shores of Skaha Lake. This usually occurs on one of our ubiquitous rainy days in Vancouver.

Suffice to say, that as we approached Hwy 97 and the reflection of the sun on the lake came into full view, our annual discussion about buying property in the Okanagan was renewed. Being real estate investors ourselves, we started to think, 'Hey maybe we should be investing our money in this area? After all, if this is where we love to come to every summer, why not invest here as well?' In fact, by the time we had arrived at our friend's place, we were already scouting out the 'For Sale' signs and asking about sale prices. By the time the second day had rolled around we were looking at a \$900K view home less than a block from our friend's house and began to calculate the probability of renting it out for 11 months of the year and having it for our own for one month every summer. Alas, we had fallen into the same trap that so many summer travelers and novice real estate investors do every year. We began to let the emotions of the moment rule our buying and investment decisions. This is the same reason so many timeshares are sold to Canadian Snowbirds every winter down in Mexico and other exotic places around the world. The sentiment and the emotion of the moment wrap you up in a cloud of poor judgment and you slowly shift away from focusing on the fundamentals.

Now don't get me wrong, Penticton and other cities in the Okanagan offer up a multitude of investment opportunities and many of them can be quite lucrative, but before you jump into any investment you have to ask yourself two simple questions;

1. Why am I buying real estate in the first place?
2. What end result does this real estate need to produce for me?

When I asked myself these questions, I came to the realization that we've chosen real estate as our investment vehicle of choice. We have a specific goal and a specific target in a specific period of time, so we need our real estate to produce specific results. Our objective is to use real estate to develop a significant net worth that will eventually produce two things:

1. Equity that can be leveraged into the ultimate lifestyle that we have defined for ourselves
2. Cash Flow that will help to create options for how we live that lifestyle.

Both of those are future needs, not current needs. The challenge with being on a holiday and enjoying the immediate pleasures of the 'house on the lake' or the 'villa on the beach' is that they create a desire for instant gratification and clash with long-term goals that can often require delayed gratification. Now I know that someone is reading this right now and you've just spent a week up at 'the cottage' with the kids and you're thinking, 'Wow that was so amazing, I want my kids to enjoy that lifestyle today! I don't want to delay gratification so long that by the time we buy the cottage our kids have all grown up.'

You're absolutely right, and if that is your goal, then make the move today. In fact there may well be a way of having your cake and eating it too. My point is simply this; Are you making financial decisions today that are consistent with your goals? Or are you letting emotions dictate your

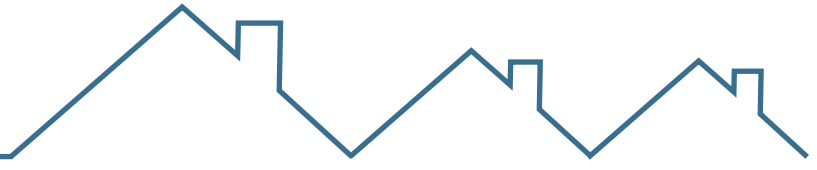
decisions and sabotaging your long term goals in the process. I always remind my clients that I am not judging their decisions, I am simply making sure that they are making decisions that are congruent and consistent with their stated goals.

Let me give you an example of what I am talking about. Let's go back to the house in Penticton with a lake view and look at some of the facts from an investor's point of view not an emotional one:

1. Cost - \$890,000 – beautiful home with a salt water pool and panoramic view of the lake, close to friends, great place for the kids to be when we come up to visit.
2. Our purpose for buying the home would be to have a place to stay when we came for our annual summer trip to Penticton and secure an investment in the Okanagan at today's prices.
3. Our 5 year plan is to increase our net worth and develop an alternative cash flow that gives us more freedom and choices in the future.

So let's analyze how this investment would match our 5 year plan:

- In order to finance it, we would need to come up with 20 to 25% for the down



payment. This would require a down payment of almost \$225,000.

- With 25% down, the mortgage would be \$667,500. The mortgage payment would be almost \$4,000.
- After including taxes and maintenance etc, we would need to rent the house for at least \$4,500 to break even.
- We would attempt to rent the house for 11 months of the year and have it for personal use one month of the year.
- The market rent for that particular house in that particular neighborhood is currently just over \$1,500 a month.
- Our negative cash flow could be as high as \$3,000 a month for the 11 months and, of course more for the month that it is used personally. This would make financing at the bank extremely difficult (even if I do know a good broker). The negative cash flow will also impact any future purchases since my debt service ratios will now be completely maxed out, thereby limiting those purchases or forcing me to not be on title with any joint venture deals.
- Assuming an 8% annual appreciation over the next 5 years, the home could be valued at over \$1.3 million in 2012. Our equity position could be just shy of \$500,000.
- We would have had to service over \$180,000 in negative cash flow over the same period.
- We would have had the enjoyment of having a great summertime home for our personal use once a year.
- 5 years later we would definitely have some equity appreciation, but not the cash flow.

Now let's take a look at an alternative use of that money that would satisfy both our short term and long term goals. Let's suppose instead, that upon returning to my home in Vancouver, I picked up the Financial Post and read about Shell's plans to build a second oil sands upgrader just north east of Edmonton at a cost of \$22 billion with the first phase of construction set for completion in 2012, employing between 3,000 and 4,000 workers during the construction phase. Suppose that I decided to take my \$225,000 and invest it into 3 solid townhouses in North East Edmonton at \$280,000 each for a total investment of \$840,000. Here's how that investment would look in 5 years:

- Each unit will attract an economic rent of \$1,500, which should be enough for the properties to break even in the first year, with the ability to increase rent every year after that and generate a positive cash flow.
- Assuming an annual increase in value of 8% (even though CMHC has already predicted a 28% return for Edmonton this year alone), the value in 2012 would be just shy of \$1.3 million and our equity position would be similar to the Penticton option, assuming we used excess cash flow in years 2 through 5 to accelerate the mortgage pay down.
- Over the same 5 year period we would have had all the appreciation with no negative cash flow. This would make the financing much easier, not only for these purchases but for any future purchases.
- After 5 years, we would have increased net worth, with a growing monthly cash flow.
- We could opt to continue to hold the properties, sell all three and use the proceeds to re-invest for personal use, or sell just one unit and use the proceeds to pay down the mortgages on the other two, thus increasing our cash flow even more.
- Any and all of these options would match our 5 year goals.

Clearly, based on my personal financial goals, option #2 is far better for us, once we remove the emotion and look at the facts. But wait, you forgot one thing – what about the kids? What about the need to enjoy the here and now? What about the desire to have a place to stay for one month a year up in Penticton? Oh I didn't forget about that, I simply figured that instead of making an investment that requires \$3,000 a month in negative cash flow, I could use surplus cash flow from my real estate portfolio and supplement it with some money from my family budget to rent an awesome house for a few weeks every summer for less than \$2,000. I would satisfy my immediate family needs without compromising my long term goals.

When you sit back and analyze your investment decisions based on fundamentals instead of emotions, it's amazing what conclusions you can come to. And if you're really good you can have your cake and eat it too.

If you still want to buy that cottage on the lake though, send us an email and we'll show you how to do that and maybe even get away with putting less money down.

Until then, Happy Investing,

Peter Kinch