

Option and The Investment Paradox

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Options

To many stock investors, an option is a familiar term. Simply speaking, an option is the privilege of buying a specified amount of a specified stock at a specified price within a specified time. Similarly, an option in real estate occurs when an investor has been granted the privilege to purchase a certain property by its owner within a specified time at a specified price. The cost of a real estate option ranges from a couple hundred dollars to over tens of thousands of dollars. It depends upon the value of the property and the holding period of the option. Although acquiring an option is not common in the Canadian real estate industry, it is the best speculative tool since it gives investors the greatest leverage.

Canadians are generally more familiar with a first right of refusal which has a similar effect as an option. A first right of refusal is usually a provision in a lease that gives a tenant the privilege to purchase the leased property or to lease a space which is adjacent to the leased property upon the happening of a certain event such as the landlord accepting a written offer to sell the leased property, or the vacating of the adjacent property. When the option is to purchase the leased property, the terms and conditions of the sale to the tenant must be the same as the accepted offer. In this sense, a first right of refusal cannot be used as an investment tool since it is a passive clause that will only come into effect when the landlord wishes to sell the property and has an accepted offer.

A real estate option gives speculators flexibility and control of the property. When the real estate market goes up, the speculator can exercise his or her option to purchase the property and flip it for a big profit. Speculators will usually target vacant lands (farm lands the most) since the increase in value is usually significant when the land is developed. Moreover, since landowners have nothing to do with the lands, they are more willing to accept an option than a building owner is. By investing a few thousands dollars and having the potential to flip the property for, say, half a million dollars, an option is a wheel of fortune to most speculators. Besides a tool for speculation, an option sometimes provides a Lease to Buy alternative to tenants.

The Investment Paradox

With rapid economic growth, real estate markets in Asia have been booming for the past few years. This unfortunately gives false hope to investors from Asia that the real estate market in Canada will be the same as in Asia. As a result, many Asian Canadians are buying condominium apartment units in Canada for investment purpose without knowing the fundamentals of real estate investment. The only equation they have in their mind is that the projected rent be high enough to pay the mortgage payments, realty taxes and maintenance fees. They believe their investments are guaranteed, since the rents collectable are high enough to pay all expenses, and will make reasonable profits over years.

Using this strategy to invest in real estate is just like gambling. There are usually some expenses that the investor has forgotten take into consideration such as agent's commission, interior maintenance cost, vacancy cost and bad debt. All of these forgotten" expenses may result in the income statement having a negative figure. When the real estate market is hot, they can sell the property and make a profit. If the market is down, however, they will have to pay for the shortage every year or sell it at a loss. The proper investment strategy is to make sure that there is a positive rate of return (usually higher than the rate of a GIC) from the property, so that an investor will not have to sell his or her properties under pressure. They will only consider selling their properties when the real estate market goes up or the capital allowance has been used up for sheltering taxes.

In my experience, there are less than five condominium apartments in Mississauga that can give a positive rate of return that may be acceptable to a prudent investor. However, due to the booming real estate market, some people have been fortunate enough to obtain significant returns from flipping condominium units since 1996. This type of real estate investing is not recommended for the average investor though.

Biography

Bryan Law is the owner broker of Prodigy Realty Corporation specialized in real estate consulting. He is also specialized in real estate investment. He has extensive real estate experience including leasing and managing properties. His specialties include lease analysis, investment analysis, lease negotiation, sales and marketing. In 1996, he founded Bryan Law Real Estate Broker, which was incorporated as Prodigy Realty Corporation in 1997. In order to promote the professionalism of Realtors, Bryan has edited and been principal author of a real estate newsletter and a real estate guide.

Bryan holds a bachelor degree of science in mathematics with honors. He is a Professional Land Economist (PLE), granted by The Association of Ontario Land Economists, a Fellow of the Real Estate Institute (FRI), granted by the Real Estate Institute of Canada, a Market Value Appraiser (MVA-Residential) and is recognized with the ICI (Industrial, Commercial and Investment) Distinction and a Member of the National Commercial Council (MNCC) by the Toronto Real Estate Board and Canadian Real Estate Association respectively.