Part I

CREATING YOUR LIFE ON PURPOSE

Chapter 1

Why Are You Buying Real Estate?

"Oh no, no. I was just wondering
if you could help me find my way."

"Well that depends on where you want to get to."

"Oh, it really doesn't matter, as long as . . ."

"Then it really doesn't matter which way you go."

—Conversation between Alice and the Cheshire Cat,
Lewis Carroll's *Alice in Wonderland*

BRIAN: Can you help me get financing for my next real estate investment?
PETER: Well, what is your goal over the next five years?
BRIAN: I want to buy real estate.
PETER: Why?
BRIAN: So that I can make more money.
PETER: What is your definition of "more money"?
BRIAN: Well, I'm not exactly sure . . . .

Brian was quite surprised when he first walked into my office asking for a mortgage and I started by asking him about where he wanted to be in five years. Much like Alice, he wasn't clear on the direction he was heading. The truth of the matter is, for many Canadians, it is not uncommon for them not to know where they want to head either financially or otherwise. People know that buying real estate is a good thing to do—after all, that's what all the financial experts say. We've all heard the quote "The greatest number of millionaires have been created through real estate." The fact that you are reading this book indicates you believe real estate would be a good addition to your financial portfolio. The question isn't "*Should* you buy real estate?" but rather the question is, "*Why* should you buy real estate?" The more I could learn from Brian about his goals, the more I could help him achieve them. There is a big difference between simply buying one rental property and building a rental portfolio.

During a television interview in the summer of 2009, the question posed to me was whether or not it was a good time to buy a cottage or recreational property. I found this question quite interesting. When I probed a bit further, the interviewer suggested that many Canadians have become disenchanted with stock portfolios and were turning to real estate as a safer, more secure investment. The thinking was that since we were in the middle of a recession and prices had fallen off a bit, now might be a good time to purchase a cottage in the lake country or a cabin at the ski hill. That was when I realized something that I've taken for granted for many years—many Canadians don't realize that real estate "investing" can be much more than simply securing a recreational property for your family's future. In fact, the term "real estate investment" conjures up different impressions and definitions for various people. This was also when I realized just how valuable "goal-oriented" planning is before taking your hard-earned money and throwing it against the proverbial wall, hoping that this investment would work out better than the last one. Exiting the stock market to enter the real estate market can produce equally poor results if you do not have a plan. This was the reason I needed to ask Brian some questions before I simply processed a mortgage for him. The first thing I asked him was, "Why are you investing in the first place? What results do you want or need from your investment?"

It's important to note that I wasn't attempting to turn Brian into the next Donald Trump and he didn't need to show me a plan to conquer world hunger. In fact, it didn't matter how aggressive or conservative his goals were, but what was crucial was that he had a clear goal that his real estate investments needed to produce for him.

Brian's answers helped me to clarify what type of investor he was and, therefore, how I could best structure his real estate portfolio. Having worked with investors for over a decade, I've discovered that there are three basic types of real estate investors:

1. The "Mom and Pop" investor who likes to buy one or two rental properties as a way of diversifying their financial portfolio and supplementing their retirement pension. Also included in this category would be the couple who want to buy a cabin on the lake or a recreational property that will provide an immediate lifestyle benefit for their family, as well as appreciating over the long-term, adding to their net worth and, ultimately, passing it on to future generations. These individuals see real estate as an important, but complementary, part of an overall financial and retirement strategy.
2. The second group is made up of those individuals who use real estate investment as their primary vehicle for wealth creation and a major component of their retirement plans. These individuals want to increase their net worth, move towards financial independence and create wealth that can be passed on to future generations. They are not full-time real estate investors, but focus on creating sufficient cash flow from their investments over the years to potentially replace one of their incomes.
3. The third group comprises those individuals who not only see real estate as their primary vehicle for wealth creation, but also as their full-time job. These individuals want to build their real estate portfolio to the point where they will be able to quit their current employment and devote their energies full time towards developing a large real estate portfolio. The majority of the individuals in this group not only see real estate as a way to create financial independence, but also as a way to achieve larger goals, some of which are charitable in nature and go beyond just a larger house or a nicer car. These individuals will need to build a large portfolio with a significant number of properties that include both the potential for increasing their net worth and developing a significant monthly cash flow.

It really doesn't matter which of these three groups you fall into—you may, in fact, see yourself evolving from one group into another. The point is, regardless of which category you fit into, it is critically important that you are honest with yourself about what you require the real estate investment to produce for you. For example, if you see yourself in either category two or three above, then the answer to my television question would be no—this is not a good time to buy the cottage on the lake. That type of real estate investment would not be the best use of your investment dollars based on your goals. If, on the other hand, you fit into category one, then now may very well be a great time to buy that cottage/family investment property. The key is understanding that there is no right or wrong answer—it's simply a matter of determining what role real estate can play in order for you to achieve your goals. Not sure? Don't worry—that's the whole purpose of this book.

This book will walk you through a process I have developed over the years called the Real Estate Action Plan. It will not only help you to determine which category of real estate investment you are in, but will also help you clarify why you are buying real estate, what results you need to achieve from your real estate investments and allow you to put together a three-phase action plan to achieve those results.

WHY YOU NEED A PLAN

Generating wealth through real estate is not about simply purchasing one piece of property then sitting back and relaxing. Creating wealth through real estate requires a serious commitment to developing a portfolio that will produce long-term results.

To successfully accomplish this, you must have clarity—a thorough understanding of what you are doing when you buy real estate. You must also have purpose—a set plan based on clear goals. Without clarity and purpose, you're simply taking your hard-earned money and saying, "Okay, I've got this money but I'm not really sure what I'm going to do with it. This sounds good, I sure hope it works." You're throwing mud against a wall, then sitting back and praying that some of it sticks!

With the real estate action plan you won't have to "throw mud against the wall." The plan provides you with the knowledge and understanding you require to make sound real estate investment decisions. You will gain a clear understanding of:

- **Why** you are buying real estate; and
- **How** you are going to accomplish the goals that you set.

Before you start to roll your eyes and say "I don't need to read another book on goal-setting or creating a business plan," let me share with you the background on how the real estate action plan was developed.

Originally, I came from a teaching background and was not in real estate. What is obvious to me today was not obvious to me when I was studying for my mortgage broker's course in Japan. When I returned to Canada and began brokering, I realized that many people were in the same boat. They had a concept of what mortgages are, but their knowledge was really nebulous—almost a necessary evil. You know you need to get a mortgage to buy a house or property, but you probably don't really understand a great deal about it. After two to three years in the brokering field, I came across a company that bought townhouse or condo projects at wholesale, stratified them and then sold them at retail to investor clients—much like buying a whole pizza and then reselling it by the slice. I agreed to work on one project with this company and, before long, I became one of their key brokers. Without even realizing it, I had entered the world of financing for real estate investors and nothing would ever be the same for me.

As a broker, typically when I receive an application from a client, I plug in the numbers based on textbook formulas and ratios to determine whether the client qualifies for a mortgage. I approached these "investor projects" the same way, but then two things happened that would change my career forever.

The first happened when I received an application from one of these condo investors. I did the formulas using the textbook method that I had been trained to use, and the result concluded that there was no way this client should qualify for a mortgage—the ratios were totally out of whack. I decided to send the application off to the bank anyway, and was completely shocked when it came back APPROVED. I didn't want to question how they approved it; certainly, I didn't want them to realize their mistake and reverse their decision, but I had to know why. I asked the underwriter, why her ratios differed from my calculations; after all, being the good student that I was, I had followed the textbook calculations to a tee. She simply said, "Well, we have this thing called a 'rental cash flow analysis,' which calculates the debt coverage ratio. It's a system used for real estate investors only." It all sounded quite complicated, so I asked some of my broker friends if they knew anything about rental cash flow analysis and the majority of them had never heard of it before—and those that had, knew very little about it. That's when I knew I was onto something. I could create a niche specializing in brokering for real estate investors. So, I decided to study, learn and write about financing for real estate investors. In the process, I began to learn that real estate investors were unique. That's when a second significant event happened in my mortgage career.

Randy, another investor client, came to me one day and said, "I've got this great deal, but I don't have much money to put down." He was very excited about the deal and I was trying to figure out how to arrange financing for that particular property. The ratios wouldn't work with a conventional lender, so I looked at some of the sub-prime options and, sure enough, I was able to find one. The interest rate was higher and he had to pay some fees, but he got the mortgage. We managed to arrange the financing and Randy was able to purchase the property, so everyone was happy—right?

Well, we were happy until Randy returned three months later because he had just found another property and needed another mortgage. Suddenly, I realized that due to the higher interest rate charged on his previous deal, the lack of cash flow wasn't helping his debt service ratios, and now it was even harder for Randy to qualify for a conventional mortgage. The sub-prime lender we had used for the previous mortgage would only allow one mortgage per client (something I didn't know while arranging the previous deal), and due to the poor cash flow on his existing property, any subsequent high-cost solutions would only serve to create a downward spiral—especially if he ever wanted to buy more real estate in the future.

Then I asked the magic question: "How many purchases do you plan to make over the next few years?" Randy answered, "As many as I can afford." If I had asked Randy that question when he first came to me, I would have structured his first mortgage differently. By not taking the time to ask the right questions in the first place, I had inadvertently put Randy in a mortgage situation that made it extremely difficult and complicated for him to get another mortgage. And that's when it dawned on me: I can't simply treat a real estate investor the same way that I treat a regular home buyer. Investors have unique needs and it is critical to determine their goals before forging ahead with their financing. How you structure each deal can have a major impact on their ability to accomplish their goals. It was a painful lesson, but a valuable one.

These two events shaped my mortgage career. First, I realized banks have different programs for investors, but more importantly, not every bank and not all brokers are aware that these programs exist. This is what motivated me to step into the world of real estate investors, creating my niche area of expertise. Second, I realized the importance of learning more about my clients' goals and looking beyond their current deals. From that time forward, I have made a point of asking every single client questions.

It started with sitting at a Starbucks and asking my clients how many properties they planned to buy in the future. The more questions I asked made me realize that, although each individual was unique and had different goals, they all faced similar issues and challenges. By asking questions and writing down the answers, I was helping my clients really analyze where they were going (or where they wanted to go) and what their unique needs were. I asked questions such as, "Where do you see yourself in five years?" It quickly became apparent from their responses that everyone had their own individual story and plan. I was quite amazed by the fact that the majority of their goals, dreams and visions were not simply materialistic in nature. I met people who wanted to help their aging parents. Some were very passionate about their church or a charity that they supported. Others simply wanted to provide their children with better opportunities. There were many examples among the investors I met, but one thing they all had in common was the fact that they all looked to real estate as their investment vehicle of choice to generate the cash flow necessary to finance their visions. I began to come to the realization that this was about something much greater than simply getting a mortgage, and my role as a mortgage broker took on a much deeper meaning. If only half of my clients actually achieved what they hoped to do, then they could make a positive impact on the world.

Put simply, it wasn't about the real estate or the mortgage—real estate was just the vehicle—it was the result that real estate could achieve for them that was really important. The mortgage was just a necessary instrument to accomplish something far greater, but without it, their goals would be unattainable. So, if I could figure out a way to help them build a portfolio, they would be able to achieve their desired results and, in a small way, I would be a part of helping their dreams become reality. And, I discovered, the larger my client's goal—the more impact it would have on the world—the more I wanted to help make it happen.

The process of analyzing the goals of thousands of investors across Canada and coming to understand how the cause and effect of today's decisions impact tomorrow's options evolved over time into the creation of my real estate action plan. This is the reason why the first question I asked Brian when he came into my office for a mortgage was, "What is your goal for the next five years?" and why I will spend the remainder of this book teaching you the lessons I've learned from financing thousands of mortgages for Canadian real estate investors.

Some Interesting Statistics

Before I delve into helping you create your own real estate action plan, I feel that it is important for you to know the following statistics:

- Roughly 4% of all Canadians will ever buy real estate as an investment. That's a number that is surprisingly low for most people I talk to. That means if you've bought even just one investment property, you are in the 96th percentile of the country.
- I estimate that roughly half of that 4% only buy two or three properties as a way of supplementing their pension plan. So, if you have bought or are planning to buy more than three investment properties, you've gone from being among 4% of the population to the top 2%.
- Taking this one step further, how many people do you think take the time to become educated, either through a real estate network such as the Real Estate Investment Network (REIN) or other real estate investment programs around the country? My

guess is that it is about half of that 2%. Now we are down to 1% of the population.

- Finally, the number of investors who understand the need to make a plan and treat their investment portfolio like a business, actually taking both the time and money to learn how to accomplish this, is probably only 10% of that 1%.

That's 10% of 1% of 2% of 4% of the entire population, if you're keeping track. I say this a little tongue-in-cheek and the actual number is not important—the point is, the number of people who actually educate themselves to this degree (such as reading and learning the material in this book) is a very small percentage. What's equally important for you to know is that if sophisticated, well-informed real estate investors represent such a small percentage of the population, so too are the number of brokers and bankers who understand how to work with them. The truth is, the average mortgage broker and banker is trained to think in what I call, "transactional terms," whereas working with investors requires a "portfolio approach." (I will be explaining these terms in more detail later in the chapter.) In other words, if you go to your regular broker or your regular bank, don't be surprised if they have difficulty understanding your unique needs. The danger, of course, is that just as in Randy's situation, neither you nor your broker will realize this until it's too late.

CREATE YOUR FUTURE ON PURPOSE

The fact that you are reading this book tells me that you have come to the conclusion that you want to buy real estate for investment purposes. My job is not to convince you that real estate is a good alternative to the stock market—I'll leave that for you to decide. In fact, you can use every exercise in this next section and apply it to whatever investment vehicle you choose. But for the purposes of this book, we'll assume that you have chosen real estate.

Whether you are just starting out and looking to make your first investment purchase or you already own a number of investment properties, you will need a plan of action. My goal is to help you create that plan on purpose. Now I know some of you are shaking your head: What do you mean by creating a plan on purpose? Well, think about it. What's the opposite of doing something on purpose? Doing it by accident. How many times have you heard someone say that they did something by accident? Unfortunately, the truth is that the majority of people you know will, five years from now, find themselves living a life which is simply the result of reacting to people and circumstances around them. Very few will have designed a purposeful life. Very few will take the time today to analyze where and what they want their future to look like. Very few will take the time to create a vision of what their life will look like five years from now. Very few will create a future on purpose.

So you've decided you want to buy real estate. Now I'm going to ask you the same question I asked Brian at the beginning of the chapter—why? What's your reason for wanting to buy real estate? We've already talked about the fact that it's not really the real estate you want so much as the results that real estate can achieve for you. So what do those results have to be for you? For some people, the answer is very clear. For others, it is more of an intangible. For still others, it is a complete mystery. When I think of why people buy real estate, I'm reminded of the book *Rich Dad, Poor Dad* by Robert Kiyosaki and Sharon Lechter. I read this book years ago, and the one concept that struck me was the idea of creating assets or investments that would eventually create a cash flow to finance your lifestyle. The ultimate goal is that you are no longer dependent on income from a job, since virtually all of your lifestyle is paid for from the cash flow created by your investments.

I've met a lot of investors who have adopted a variation of this strategy, but when I started to analyze the investors' thought processes I discovered one flaw. Basically, the process worked like this:

- You start with a job or business from which you use any excess money to purchase investments.
- These investments create a stream of cash flow.
- This cash flow is what you use to live your lifestyle.

Here's where I started seeing the problem:

- The average investor has a limited amount of excess cash to invest.

- The amount of money they have to invest determines the nature and type of investment they make.
- The type of investment they make determines the amount of cash flow they produce.
- The level of cash flow they produce, in turn, determines their lifestyle.

Correct me if I'm wrong, but this scenario sounds a lot more like a lifestyle lived by default, rather than one created on purpose. At the end of the day, you end up living a lifestyle based on whatever cash flow you receive from whatever investment you can afford. That's why many investors wake up five years from now wondering why it didn't work.

Don't get me wrong—I believe the person who buys "whatever kind of investment they can afford" is infinitely better off than the majority of Canadians who do not invest at all and simply wait to retire hoping to collect their old age pension. But that's not who you are—we've already determined that statistically, you're not the average person. You wouldn't be reading this book if all you wanted to do was simply buy one more property. So, what if we took a different approach and started with the end result in mind?

As I mentioned earlier, I believe it's not the real estate that you want, but rather the results that real estate can produce, and with those results, you'll be able to create the lifestyle you want. If we're completely honest with ourselves, what real estate investment is really about is attaining your desired lifestyle at the end of the day. So, why not start with the end result in mind?

1. Determine what type of lifestyle you would like to have in five years from now.
2. The type of lifestyle you want to have will determine the amount of cash flow you will need.
3. The amount of cash flow you need to live the life you want will determine the type and nature of investments you will need to make.

4. This will bring you back to where you are now—your current job or income.

I know some of you are saying that sounds all good and well, Peter, but it still doesn't address the question "How much real estate can I afford to buy? It's all fine and dandy to create some fantasy vision of an ideal lifestyle, but given my current circumstances and with the amount of money I have in savings, I can't afford to buy the number of properties I need to create the cash flow required to pay for my ideal lifestyle. Maybe I'm better off creating a more 'realistic' goal based on what I can afford."

I know exactly what you mean. But in reality, all you've done is identify an obstacle. And that is precisely why you need an action plan. You need to clearly define your obstacles and then put a plan of action into place to overcome them.

By starting with the end result and working backwards, you will be amazed at how much clarity you get by identifying and then overcoming the obstacles you will encounter en route to accomplishing your goal. You will be able to clarify exactly the kind of lifestyle you want to live, figure out how much cash flow you will require, figure out the type and nature of investments you'll need, identify your obstacles based on your current realities and figure out the solutions to overcoming these obstacles.

A NOTE ON REALITY

Understanding "reality" is crucial. It doesn't matter how grandiose your vision is, there is no such thing as a realistic or unrealistic goal. People often have a lifestyle vision—a dream—but don't think it's realistic.

A goal cannot be realistic or unrealistic, but what's required of you to accomplish that goal may be unrealistic given your current circumstances, or sometimes the goal is realistic, but the time frame is not. You don't have to change the goal—just the time frame.