LANDLORDING IN ONTARIO

No-nonsense, no-fluff, practical advice based on real-world experiences, supported by powerful, personally developed analytical and property management tools

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How tenants pay their rents also provides insight into the demographic mix of your prospective tenants. Online users are less likely to be 'old school' or to be troublesome about change in general. Online users appreciate the convenience and time savings of online payments, are likely to own a computer, more likely to have an email address, perhaps be more sophisticated in general, and more responsive to things that make sense to be changed. Those are the kinds of tenants I like.

You may have questions in addition to the above and some may be very specific to the property. The goal here is to learn as much as you can about whether the property appears financially viable at first glance to justify the significant time you'll spend touring the property and doing a deeper analysis.

With the number of unreasonably priced investment properties on the market, finding the needle in the haystack can be a daunting task. A list of questions like the above can help you quickly bale the haystack down to a manageable size.

What is capitalization (cap) rate?

When I first started learning about investment properties, I was taking courses full time, and it still took me months to fully understand what cap rate *really* means.

Cap rate technically expresses the relationship between a property's current year's net income and the value of the property. It helps but doesn't completely determine the value of an investment property and its potential return *on* and *of* an investment.

Cap rate is quickly and easily calculated by dividing the NOI by the current value or sale price of a property. Using the seller's asking price tells you how much cap rate they are saying they're offering you. If they truly understand what cap rate is, then the cap rate can be a significant tool in the negotiation process for determining a mutually acceptable purchase price.

Unfortunately, most sellers and their realtors don't get it. They may state that the property is a 7 cap but when you drill down, you eventually prove (with the seller's reluctant agreement) that the property is actually priced at a 5.5 cap. You can then reasonably argue that the seller was offering a 7 cap and should therefore honour that offer by adjusting the price downward to reflect that.

Of course, with investment properties in such high demand, most sellers will just move on to the next buyer who doesn't understand any of what we're discussing here.

What I struggled with, and what no one seemed to be able to explain to my satisfaction, was why cap rate matters so much. How did the marketplace

and individual buyers and sellers determine what the cap rate should be? For example, who (or what) decided that multiresidential investment properties in Ontario should sell at around a 5.0 cap rate?

The key attraction in using cap rate is that you can financially compare two widely differing multiresidential investment properties. A poorly managed nine-plex could be worth less (not worthless) than a well-managed six-plex.

Simplistically, I think of cap rate as if you were asking yourself what rate of return *on* your investment *and* rate of return *of* your investment would you want to make as the *buyer* (not as a seller).

As a seller, you might similarly ask yourself, what rate of return *on* investment *and* rate of return *of* investment are you willing to give to the *buyer*.

Return *of* investment is how long it took for you, using the property's cash flow, to get back your initial cash investment. For example, a property generating $40,000 cash flow (money in your pocket) per year that you paid $400,000 to purchase will take 10 years to get your investment fully repaid. Note that the calculation of cash-on-cash return with the principal paid down on the mortgage is a better indication of return on investment than cap rate is, so don't get too caught up in this analogy.

Return *on* investment is how much money you made from your initial cash investment over a period of time (e.g. 10 years). It can be expressed as a ratio or percentage. The actual calculation of return on investment (not the cap rate calculation) involves complex calculations and advanced financial understanding of concepts like internal rate of return (IRR), which is beyond the scope of this book. You should speak to a real estate accountant or specialist real estate advisor for more insight into how to assess return *on* investment of an income generating investment property.

How do you decide what the cap rate should be?

Remember that the cap rate is always quoted from the perspective of the buyer. It represents what rate of return the buyer can reasonably expect to receive, based primarily on the net operating income of the prospective property.

The buyer always wants the highest cap rate possible. 7% is a significantly better return for a buyer than 5%. Conversely, the seller always wants to give the buyer the lowest cap rate. The lower the cap rate, the higher the sale price of the property. You'll see how this works shortly.

There are two common ways for buyers and sellers to establish cap rate. Sometimes both are applied.

The first and most common way is to compare the cap rates of comparable types of properties that have recently sold in the area. However, that requires access to income and expense information that is not often

available, even to realtors. And it still doesn't really answer the root question. Something had to be the causal effect to establishing the cap rate.

The second way is causal, but most investors don't think directly in those terms; they sort of stumble into it. The cap rate is set by a combination of the cost of borrowing money and the reasonable expectation of what an investor should get back for the investment risk they take.

For example, most people would consider government bonds to be among the least risky financial investments one can make. Of course, the low risk usually comes with a low rate of return. Compare the return and respective risk of other investment vehicles such as stocks, term deposits, starting your own company, and so on. If the return on investment for real estate was the same as that for bonds, why would anyone ever want to invest in real estate?

So, the operative question is, how much more return above the bond rate would be satisfactory for taking on the added risk of investing in real estate and managing it? Based on my experience, the answer I've repeatedly found is that a 'reasonable' rate of return appears to be 3.5 to 4.0% above the 10-year bond rate. In other words, the cap rate is 'relative' not 'absolute.' The rate of return *on* investment moves up and down with the bond rate.

The above is a gross over-simplification, but everyone needs to start at a baseline understanding and then refine their knowledge as they better understand all the influences that are in play.

We also know, for example, that the downward pressure on cap rate is further influenced by the high demand and low supply of investment property inventory in Ontario. Buyers are prepared to take a lower profit and give more to the seller to purchase a multiresidential property than they might give for other types of properties that are more readily available.

Some simple arithmetic will demonstrate the enormous impact that a small change in cap rate can have. As previously discussed, cap rate = NOI / purchase price. Consequently, purchase price = NOI / cap rate

Assume a property generates a 'true' $50,000 NOI. The buyer's desired cap rate is 7.0% so the buyer's offered price is $715,000. However, the seller is only willing to offer a 5.0% cap rate, which yields an asking price of $1,000,000.

Absolutely nothing changes about the property except the desired cap rate between the buyer and seller,

When a bargain hunter investor declares in a 5 cap market that they will only look at properties with an 8 cap before they even look at a property, what they're really saying is that they want a property with a high NOI at a deeply discounted purchase price. Well, shucks and golly gee, don't we all want that?

Such buyers are a waste of time so, as a seller or realtor, you should move on to the next prospect unless your property is severely distressed.

There are large real estate companies that publish quarterly and annual reports on cap rates for all types of properties within major geographic areas. They're readily findable on the Internet.

What cap rate doesn't tell you

Cap rate can provide you with some solid insights into the financial performance of a property but, as we've already seen, you shouldn't rely on this, or any one metric, to make a purchase decision. Cap rate doesn't tell you enough by itself to make a fully informed investment decision.

It doesn't factor in financing and closing costs so it won't tell you how much profit you'll put into your pocket.

It doesn't consider the state of repair of a property and therefore the potential extra money you may have to put into major capital costs like windows, boiler, roof, etc.

It doesn't project appreciation potential or geographic growth potential. As we discussed, proximity to a highway, new retail plaza or transit station will likely have a positive impact your property's value. Conversely, a neighbouring cemetery, garbage dump or a loud, noisy or smelly industrial property may hurt or hinder property value.

Cap rate doesn't reflect the local crime rate and types, tenant demographics, the quality, construction, size, and age of a property, or the proximity of your property to amenities like transit and shopping.

All of the above should factor into your purchase decision.

While I focus primarily on multiresidential properties in this book, many of the investment principles apply equally to other types of income-producing investment properties, such as retail plazas. Therefore, additional considerations not addressed by the cap rate for a retail plaza could include how much time remains on ease lease, what special considerations (such as lease options) were given to each tenant, whether escalators and elevators are leased or owned, easements on the land, title restrictions, and more.

Cap rate assesses a property's value based on one year of NOI. It doesn't forecast increases in operating and financing costs. For example, will NOI drop within five years because electricity costs have risen 65% or the mortgage rate has doubled over that time, or both, while rent controls prevent you from raising the rent more than the permitted annual guideline increase?

There may also be issues specific to the prospective property. One property for which I won a conditional offer but failed to close had a right-of-way issue. On another property that I did purchase, I discovered during due diligence that the seller had botched a 10-year-old environmental cleanup by removing an oil tank but then put back the contaminated soil to save money.

When would a seller give a higher cap rate?

Remember that cap rate is quoted form the buyer's perspective. A higher cap rate to the buyer means a higher return on investment in general terms to the buyer. That higher rate of return to the buyer is reflected by the seller's lower sale price.

For example, a buyer wants a 6% cap rate on a seller's NOI of $50,000. The buyer's offered price is therefore $50,000 / 6.0% = $833,334. However, the seller says that their property is in high demand and the cost of borrowing money is very low. Therefore, they're only willing to offer the buyer a 5% return. That means the seller is demanding $50,000 / 5.0% = $1,000,000.

Once again, nothing else about the property has changed—only the buyer and seller's respective demands on what the cap rate should be. The 1% difference in the cap rate resulted in a $166,667 difference in property value, which is 20% more ($166,667 / $833,334) than the buyer's offer. It could be enough of a difference to kill a deal.

So why would a seller give a buyer a higher return on investment than prevailing market rates when it would mean a lower sale price to them?

In short, it's because the property is hard to sell. A common reason is that the property is 'stigmatized.' A stigmatized property is one where the buyer or tenant shuns a property for unfounded reasons unrelated to the property's physical condition or features. Examples include any death of an occupant whether by natural or unnatural causes, serious illness, the property is haunted, or the property is located next to electrical high-tension wires or a cemetery.

Stigmatisms currently don't have to be disclosed by Canadian provincial or federal law. It's up to the buyer to determine whether a stigmatism exists. This legal position is still highly controversial. In its simplest form, Canadian law states that anything that would affect a buyer's decision to purchase a property, or to decide what price they offer, must be disclosed. Yet, stigmatisms are considered to be somewhat irrational or otherwise not based on fact or the law, so such items and topics would not form part of the considerations of a rational offer. (I did say it was controversial.)

Another reason a seller might give a higher cap rate to a buyer is because the property is 'distressed' in some way. Often it's because the property is in a poor state of repair and would require a lot of time and money to bring back up to the area's generally accepted standard of living or even to various code standards. Such properties are euphemistically called 'fixer-uppers.'

To repeat, cap rate doesn't consider a property's state of repair and therefore doesn't take into account the one-time capital cost expenses. However, knowing that, as a buyer, means you can offset these one-time costs by asking for a higher cap rate, which will result in a lower purchase price.

Many sellers and realtors don't realize, or refuse to accept, that the market value of a real estate property assumes that the property is in a good state of repair, the land is employed for its 'highest and best use,' and the income it generates reflects the all the local positive and negative market influences. The overall assumption is that the buyer will not have to lay out any immediate cash for any repairs or maintenance.

A property next to a big shopping mall or subway station should fetch more rent than a comparable property six blocks away from such amenities.

'Highest and best use' refers to the legal use of the land and its improvements (buildings) to create the greatest return on investment. For example, a gas station on the corner of Main St. and Main St. in the downtown core of a large city might generate $5,000,000 in revenue with a profit of, say, $250,000 to the owner. Tearing down the gas station and erecting a six-storey office building that generates $12,000,000 in rental income with a profit of $800,000 might be the highest and best use of the same physical parcel of land.

No seller should expect to receive market value for their property if any of the above isn't true. To expect otherwise, the seller is essentially saying that they want the buyer to pay the seller for the property's future potential even though the seller did nothing to deserve a share in that future potential.

If the seller wants to benefit from that potential, then the seller should have invested the time and money to realize that potential to make it real.

An uncommon twist to the above is the situation where the current owner invested more money into improving a property than could be justified by the consequent increase in income.

The seller may have had pride of ownership or lived in the property and wanted something upscale for themselves. These sellers then want the buyer to pay for the seller's over-investing mistakes. This might work for a residential sale but it doesn't work for investment properties of any kind. The property's income *must* be able to carry the operating and financing costs I previously described. Overpaying for the property to recover the previous owner's over-spending could mean that there's not enough income for you to make a profit. Worse, you might have to put more money in to cover those costs.

If you don't quite understand right now, don't worry. You'll see what I mean when we start doing the math.

Suffice to say that anyone who pays a seller for the seller's over-investing mistakes is only transferring the consequences of those mistakes to themselves.

For the vast majority of investors, a property must 'cash flow,' that is, it must generate enough income to cover all the costs described earlier in the section, '*What costs should the property's income cover?*'

Determining Financial Viability of a Property

Financial indicators and ratios help the investor-owner to understand, before and after the purchase of a property, if it's financially viable and by how much.

Less obvious but equally important, these indicators are also used by lenders as the basis for their lending decisions because the property and its income are invariably used as security, called *collateral*, for the loan.

There are three primary methods that are generally applied to estimating the market value of a property: sales comparison approach, cost approach, and income approach.

The fundamental principle of the cost approach in determining market value is that a buyer shouldn't pay more for a property than it would cost to build an equivalent one. A property's market price is therefore determined by the cost of land plus cost of construction and minus depreciation of the building and other tangible assets. The cost approach is most often used for new properties.

The sales comparison approach is the technique overwhelmingly used by residential realtors. Its underlying premise is that each and every individual feature of a property has a bearing on the overall property value. Therefore, the total value of the property is a sum of the values of each feature. For example, a house with a fire place, double-car garage, quartz kitchen counter, and finished basement is worth more than one that doesn't have any of these features. It is, in effect, a derivative form of cost approach, except that the comparison approach looks at all similar properties within a very localized area, typically a one- or two-block radius from the subject property.

Also, while it may cost the same to install kitchen cabinets anywhere within a city, the value of those kitchen cabinets can be greatly affected by the location of the house in which they were installed. That is, the value of the four earlier mentioned amenities can be substantially higher in one part of the city than another, even only a few blocks apart.

The comparison approach is a useful and intuitive method for selling homes, but it has limited value for assessing the value of income-generating investment properties. The impact of location on the value of income properties is assumed to be reflected in the individual rents that the property produces, as earlier discussed.

What we need is an approach that compares two widely different income-producing properties using a common base of financial information for comparison.

The income approach to property valuation meets that need. It's based on the principle that the *value* of a property is directly related to its ability to produce cash flow. That doesn't mean just looking at the numbers, though.

You should also take into consideration the many market influences that can impact cash flow, as well as finding data, where possible, on properties you consider comparable to the property you're evaluating.

A capitalization technique used by more sophisticated investors is the discounted present value method. This method encompasses a forecast of future income generation over a set period of time and the expected return on investment after selling the property (disposition) at the end of that period. However, I don't use this latter technique in my own decision process because my investment strategy doesn't include ever selling the properties I buy. Therefore, I don't spend any time looking at future value. For me, every property has to cash flow from the outset, with the potential to increase that cash flow by various means discussed later in this book. I'll be presenting a very detailed income approach further on.

Below are the financial indicators and ratios I use in determining not only if the property is financially viable and worth purchasing but also whether I stand a chance of being able to finance it.

Everyone in real estate is focused on the former but I've found that few sellers and realtors make any effort to understand whether the purchase price of a property, relative to its income stream, will carry the cost of financing. And that explains why failing to secure financing continues to be the number one reason conditionally sold property transactions don't complete.

Net Operating Income (NOI): we've discussed this particular value in some detail already. It's used to determine either cap rate or a ballpark property value.

Net Operating Income = Total Income – Total Operational Expenses – Vacancies and Bad Debt.

All mainstream lenders and CMHC include Vacancies and Bad Debt when determining their appraised value of the property for purposes of determining how much they will lend (LTV) you, irrespective of whether the property actually had any vacancies or bad debt in the past year or more. They will generally assume the most recent vacancy rate for the geographic area as published by CMHC. The rate is expressed as a percentage and deducted from the income of the property.

Lenders and CMHC will also deduct the income of any unit that is not legal. This is because the unit could at any time be shut down by any number of government agencies for non-compliance, including fire code, building code, electrical code and city by-laws. Lenders want assurance that the property will still carry the debt load if this 'illegal' income 'disappeared' temporarily or permanently.

New Section

I integrated a third party's Canadian mortgage calculator worksheet into my spreadsheet. I can't provide you the formulas, since the worksheet is the copyright material of that developer-author. You'll see the tabs at the bottom of the images labelled 1st Mortgage and 2nd Mortgage, and some formulas in my spreadsheet refer to those worksheets. You'll either have to manually plug in your own mortgage numbers in the financing section of the spreadsheet or you'll need to find a mortgage calculator worksheet and integrate it into your spreadsheet.

Alternately you can obtain an 'as is' copy of the spreadsheet from me by following the instructions in Appendix C.

What-if scenarios

Once you have a copy of the spreadsheet built, and assuming everything works exactly as it's supposed to, you'll see first-hand the relationships, interdependencies, and impact that changing any one value has on all the others. Here are some more common and notable 'what-if' exercises and scenarios. In each situation, look at what happens to BER, DSCR, cash flow, cap rate, CoC (with mortgage repayment) and PCF.

Increase vacancy rate by 2%. Vacancy is effectively a cost. The higher the vacancy, the lower the rent you'll collect. The more units you have, the less impact from vacancy you'll feel. It's a lot less emotionally draining to have a unit empty for two months in a 10-plex than a single-family home or duplex.

Increase one utility bill that you pay for as a landlord by 25%. In Ontario, it's common for each tenant to pay their own electricity bill. The gas bill, most often associated with heat, is often included in the tenant's rent.

You'll always have common area electricity cost, which may include coin operated laundry machines, lighting, fire alarm, elevator, and water heaters.

Remove the maintenance and property management (PM) expenses. This is what many sellers and realtors do. Every property suddenly becomes an excellent cash flowing opportunity. No wonder, since these properties magically repair themselves and don't require management.

Perhaps you received actual PM and maintenance costs from the seller and they may even appear reasonable. Nevertheless, you need to plug in the lender's and CMHC's values here so that you can determine your chances of succeeding with property financing. Not using their numbers will lead you to either failed financing or a dramatic increase in the down payment you need to bridge the gap between what a lender will loan you and the purchase price you pay.

Decrease the mortgage interest rate by five basis points (0.05%). Note especially the cash flow value. It's one of a lender's most common hurdles. Lenders routinely lose business to neophyte investors and borrowers of every

kind based on such small interest rate spreads. The interest rate is so ingrained into the consumer psyche that they think a tiny spread like 0.05% over 25 years must have a dramatic effect.

The truth is, it's not as significant as you might think. There are other mortgage terms that are much more important to win, especially getting a better amortization period if you want it, and removing a lender's first right of refusal on refinancing. You absolutely must ensure that this devastating latter clause isn't in your mortgage document. See the section, '*Assume existing first mortgage*' in the section, '*Creative financing alternatives when obstacles arise*' for more details.

Increase the amortization rate ('am') from 25 years to 30 years. Note especially how it impacts your cash flow. It can have the single greatest impact on your cash flow. As previously discussed, you pay more interest, of course, but as long as your property is always cash flow positive, meaning the tenants are paying the financing bills, you have more money in your pocket today. That's my own personal retirement goal.

Add or subtract one dollar to the expense total. Depending on the cap rate of the opportunity, you could see as much as a $20 change in property value. '$1 NOI = $20 Joy' (or Oy! if losing money), assuming a 5 cap.

Add 1% to your down payment and look at your cash flow. The more money you put in, the lower the loan you require and the lower your financing fees will be. Therefore, the higher your cash flow and money you put in your pocket.

Sometimes you have to put a bit more in than you wanted to because the lender doesn't accept your agreed-to purchase price as the appraised value. There are many reasons why you might have to put more down payment than you originally planned. This spreadsheet can tell you what your threshold is before you have to drop the opportunity. It's a good thing to know before you spend two months doing due diligence on the property. In my spreadsheet example, the 1% extra down payment (26%) resulted in over $1,000 more cash flow.

Change the cap rate from 6% to 5% and *vice versa*. Of all the variables that can impact your cash flow, none compares to the change that a 1% change in cap rate can cause, for better or worse. In my spreadsheet example, the $2,200,000 property dropped in appraised value to $1,844,000, a $356,000 (16%) difference!

Once again, I have to remind you that purchasing an investment property at a low cap rate with less than a 25% down payment could mean significant future trouble for you. The modest change in cap rate has such a profound impact on property value that it's worth going through a detailed what-if exercise.

Assume an investment property generates $100,000 per year in total income. We'll be ultra-conservative and say that operational expenses, which exclude financing and one-time capital costs, consume 50% of the property's income. That leaves $50,000 before financing. This is your NOI. $50,000 NOI / 5 cap = $1,000,000 baseline property value.

If you owned the property outright, that is, you have no mortgage, then putting this much money in your pocket may be okay for you, especially if you want relatively passive income. Just remember that too much equity is 'dead money.' That potential money is not working for you to fuel financial growth.

The house of cards that is an over-leveraged property

Now, let's put into practice, using the spreadsheet, what we discussed about over-leveraging a property.

Assume your expenses (not interest rate) rise 5% in one year but Ontario's rent control guidelines allow you to increase rents by only 1.6%. Therefore, you experience an overall decrease in NOI of 3.4%.

$50,000 NOI x 3.4% decrease = $1,700 less than last year. Your new NOI is $48,300. $48,300 / assumed 5 cap = $966,000. Your $1,000,000 property (-$966,000) lost $34,000 because of a $1,700 decrease in your NOI, over which you had no control (e.g. increase in electricity and property tax). Every $1 decrease in NOI costs you $20 of lost property value.

But there's more. Financing is deducted from NOI. A 25% down payment on a $1,000,000 property leaves a need for a $750,000 mortgage (75% LTV). Assume mortgage interest is 3.0%, fixed, five-year closed, 25-year amortization. According to Canadian law for mortgages (compounded semi-annually, not in advance), monthly principal and interest (P&I) = $3,550 per month or $42,600 per year. A $50,000 NOI - $42,600 mortgage = $7,400 cash flow (profit) before taxes and before paying for any major capital costs (e.g. new roof, furnace, etc.).

Now, assume all the factors above remain exactly the same and your mortgage comes due. The interest rate (not cap rate) has risen 2.0% so your monthly (P&I) at 5% = $4,360 per month or $52,340 per year**. A** $50,000 NOI - $52,340 new first mortgage = **-**$2,340 per year *loss*. You're paying more than you're making, and *before* inevitable capital costs. One subsequent major capital expenditure could put you in deep financial trouble.

In real life, you'll have paid down some of the mortgage principal and you may have been able to increase the rent income. However, expenses, vacancy and bad debt likely also increased. There are many influencing factors, but the point is that a 2.0% increase in only the interest caused your property to negatively cash flow and the first major capital expense (e.g. new roof) would present a significant losing proposition.

But I'm not finished. Let's say that instead of buying the $100,000 NOI property at a 5 cap for $1,000,000, you desperately wanted the property, got caught up in bidding war and won the property at a 4.5 cap. That means you paid $1,111,100 purchase price ($50,000 NOI / 4.5%). You apply the same 75% LTV and obtain an $833,325 first mortgage.

Using the same 3.0% interest parameters as above you pay $3,944 per month or $47,324 annually. Your cash flow dropped from $7,400 to $2,676 per year.

Like our last what-if scenario, if the interest rate rose from 3.0% to 5.0%, your new first mortgage would cost $4,847 per month or $58,160 per year. A $50,000 NOI - $58,160 mortgage = **-**$8,160 per year out of your own pocket. You've dug yourself an even deeper hole than you would have with the 5 cap purchase.

But that's still not the worst of it. We've talked in depth about how cap rate is partially a measure of return on investment (ROI). Today, maybe a 4.5% cap is okay if the 10-year government bonds were less than 2%. Let's say government bonds rise from 2% to 4%. Real estate buyers take on more risk and workload than does a bond buyer. They therefore demand a higher return on their investment, which is reflected in the cap rate they require.

Assume all buyers (that is, the market in general) are demanding a 6% cap for the earlier property that you purchased for $1,111,000 ($50,000 NOI at a 4.5 cap). To keep things simple to demonstrate the point, nothing else changed. Your $50,000 NOI divided by the newly demanded 6 cap = $833,334 appraised value, meaning the property you bought at a 4.5 cap for $1,111,000 is now valued at $833,334, for a net loss of $277,866.

With your 75% LTV, you would have put 25% down ($277,750) when you first bought the property and obtained a first mortgage of $833,250.

Absolutely nothing changed about the condition, income, expense or any other aspect of your property except that the market demanded a 1.5% increase (from 4.5% to 6.0%) in return on investment. Your mortgage is almost exactly the same as the value of your property.

Not only have you lost your 25% down payment of $277,750, which is all of your equity, the lender will only loan you 75% of the new value of your property: 75% of $833,334 = $625,000. Perhaps you paid down $50,000 of your expiring first mortgage, so your original $833,250 mortgage is now $783,250. But the lender will only give you $625,000. You have to come up with $158,250 out of your own pocket or from some other source.

To recap, you bought the property at a 4.5 cap, interest rates rose, causing the cap rate to rise to 6, which not only wiped out all your equity but it forced you to come up with another $158,250 or go into default.

By the way, the lender still got all their money and they still have your property as collateral.

New Section

Strong rental agreement

Providing a strong legal and robust rental agreement to a tenant applicant, to review before they send in their application, can contribute enormously to weeding out bad tenants. Bad and professional tenants are looking for lazy or poorly informed landlords. When they see a strong rental agreement, they'll almost always move on to look for easier landlord pickings.

A strong rental agreement is much more than a qualification tool. It can reduce miscommunications, manage tenant expectations, be a major deterrent against frivolous claims of every kind, control operating costs, reduce potential insurance claims, establish responsibility and possibly culpability in the event of a catastrophic event, minimize potential police, fire and other claims, and create an overall better landlord-tenant relationship. I'm willing to bet that there will be issues and concerns addressed in my rental agreement that you may not know, and that you should be aware of.

To me, it's critically important to cover off every anticipated angle that a tenant might want to leverage or exploit. That's why this topic is a dedicated, separate section in this book, rather than an additional qualification process item.

A strong rental agreement will discourage professional tenants from renting from you, discourage tenant bad behaviour, and discourage tenants from trying to cut corners or take advantage of you.

Some tenants may feel it's their right to do certain things, or that the 'rich landlord' shouldn't mind if they do. These include using the building's water to wash their vehicles, sewers to dispose of chemicals and oil, the common area electricity to do repairs or run temporary, or even permanently, installed appliances, or damaging parking lot and other common areas with their tools, etc.

My rental agreement makes it very clear what the tenant can and can't do, and I believe it can significantly improve a landlord's chances of winning a case with the LTB tribunal.

While my rental agreement may seem lengthy, and perhaps even unwieldy, to my knowledge, I've never once had a tenant abandon a rental application after they received my rental agreement.

Lease or rental agreement?

Before we get started on the contents of the rental agreement, you should decide whether you want to use a lease or a rental agreement. They're two different things.

Again, I'm reminding you that I'm not a lawyer, so the following is my general understanding of contracts and must not be taken as legal advice.

An agreement of any kind requires several elements to be present for it to be legally enforceable. These include legal and correct names and signatures of the parties, the signatory(s) must be competent to sign, legal description of the product or service (property), consideration (exchange of something for something), and start and end dates.

A *lease* agreement is a legally binding contract that grants a tenant the right to use your property for a specified period of time, in consideration of rent or other compensation.

A rental agreement has no end date. This is an anomaly of contract law. The RTA specifically states that when a lease agreement ends, it automatically converts to a month-to-month rental agreement. The tenant can't be forced to move out and you can't increase the rent after the lease ends by any amount you wish, if the property is subject to rent control. There are only a few provisions in the RTA for when a landlord or tenant can declare an end date.

Uninformed investors, lenders, and insurance companies all love to see every tenant with a lease. They believe that the lease stabilizes a property's income stream.

The reality, as of this writing, however, is that the landlord gives up eviction rights permitted by the RTA with little *real* value remaining that would favour using a lease. A fixed-term lease prevents you from undertaking no-fault notices of termination, such as eviction, so a landlord can personally use the property, eviction so the new owner can move in, eviction for renovation and demolition, and eviction when a tenant regularly pays the rent late (form N8).

The principal benefit of a lease is that the landlord has a contractually guaranteed, projectable income for the term of the lease, typically one year for residential rental properties and five years for retail properties.

The problem is that an aggrieved party is obligated, under law, to do everything reasonable within their power to minimize their losses. Your greatest tangible loss would typically be rental income but with vacancy rates throughout Ontario being the lowest in living memory, odds are high that you'll rent out the unit within 30 days. Therefore, even though you might have been guaranteed one year of income and only received six months, SCC will only award you the rent while the unit was vacant, which might be a month, plus court costs (maybe).

You'd have to sue the tenant in a higher court in order to win 'expectation damages.' The cost and time to do so, versus the potential award you would receive, is generally prohibitive.

As discussed earlier, even if you won your case in the LTB or SCC, and were awarded your losses, you'd still have to enforce the monetary judgment yourself.

So why have a lease? Now that I have convinced you not to use a lease, one of my partners convinced me we should have a lease in place anyway. They

said we'd never have need of the lost eviction rights, and the one benefit of having the lease actually occurred literally a couple of months after we made the switch from monthly rental to a one-year lease.

Leases discourage people from using rental facilities as a short-term measure while they transition from one place to another. It happened that a retiring couple was waiting for a unit to open up in a retirement living facility and was looking for a place to live for six to nine months after they sold their home. They never mentioned this in their interview or on their application. It was only when we delivered to them a one-year lease that they asked if they could get out of the lease early, which defeats the purpose of having a lease.

The main reason for not wanting too short a tenancy is that I don't do the tenant screening, unit tours, and consequent paperwork. I don't have the patience, time, or inclination, and I simply don't enjoy this aspect of the landlord job, so I pay a tenant specialist to do this for me. It becomes prohibitively expensive if a tenant moves out after only six to 12 months.

For me, the ideal tenancy term under Ontario's current legislation is three years.

My lease agreement - Overview

Once again, I need to remind you that I'm not a lawyer and that using any of the content in this book, or the handouts, is at your own risk. You indemnify me from … everything, and you agree to seek expert legal advice before using any of this content.

My rental agreement is actually a lease agreement, as discussed immediately above. It comprises about three pages for the main body of the agreement and another three pages in small type for its Schedule A.

The agreement outlines the tenant's and landlord's responsibilities to each other.

Topics covered in my lease agreement

The following is a detailed discussion of my lease agreement.

<u>General maintenance</u>

Before going through each item in the agreement, you must understand that the RTA makes it *your* obligation as a landlord to maintain the property in good repair. You can't transfer that obligation to the tenant as part of the tenancy agreement.

A premise of almost all bodies of law is that you can't contract out of law. In other words, you and another person can't agree that something is okay when the law says it's not okay. For example, you can't put into your tenancy agreement that the tenant will look after the property and you don't have to do

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