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Why buying a REIT is more profitable than a condo

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Borrowing costs are cheaper, and demographics work in your favour

Investors thinking of taking a flyer in the real estate market by purchasing a condo may be able to make more money by buying real estate investment trusts (REITs) that own apartment buildings.

That's the conclusion of a study by Macquarie Capital Markets Canada Ltd., which found that REITs produced total returns that handily beat those from condos, both in the red-hot Toronto market and Calgary's cooler one.

The performance gap was largest in Calgary, where Boardwalk REIT BEI.UN-T returned 16.3 per cent last year, compared to a loss of 2.8 per cent on the equity in a typical condo. In Toronto, Canadian Apartment Properties REIT (CAP) CAR.UN-T returned 29.6 per cent, compared to 11.3 per cent for the condo investment.

The one-year results were no fluke. The firm also looked over the past three years, and found that owning apartments through the stock market beat owning a condo in every period but one.

Macquarie picked Boardwalk and CAP for comparison purposes because each of the REITs owns apartments in the city in which its results was pitted against that of a condo. (A REIT is a company that raises money from investors and buys a pool of real estate properties, returning profits to its shareholders.)

The comparison matched each REIT's results against the total return, from rent and capital gains, produced by a condo with 900 square feet of space, two bedrooms, a small balcony and one underground parking space. The study assumed the condo was bought with 40 per cent equity, the balance borrowed through a mortgage. This capital structure is similar to that of the REITs, which also use debt.

Almost everyone has heard of someone who has bought a condo, rented it out, and had the monthly income cover the mortgage and fees, with a bit left over as profit. Even more enticing is the potential for additional upside from capital gains.

But while some tales of riches through condo flipping may be true, the Macquarie comparison suggests even greater amounts of lucre can be garnered on the stock market, with less effort.

"If you're going to buy a condo for an investment, I think ... it's better to buy the REITs," contends Michael Smith, the Macquarie analyst who conducted the comparison.

He cautioned that his review applied only to condos as investments. "If you're buying a condo to live in, then it's a different story because then lifestyle becomes a factor," he said.

REITs have some obvious benefits over condos. There are no calls in the middle of the night from tenants asking for repairs, no losses from deadbeat tenants and no real estate commissions.

Demographics are also favourable, as immigration into cities boosts the demand for rental accommodation. Meanwhile, most developers are concentrating their efforts on building condos and there is practically no construction of new apartments. That leads to a restricted supply of rental units, high occupancy rates and upward pressure on rents.

The apartment REITs also enjoy a low cost of borrowing, courtesy of government loan guarantees from Canada Mortgage and Housing Corp. Few companies have this leg up, which puts REITs on par with individuals who borrow with CMHC backing. "It's a good business, owning apartments," Mr. Smith said.

Two ways to be a landlord

In recent years, apartment REITs have usually outpaced returns from condos.

Holding period	Toronto Condo returns*	Cap REIT returns	Calgary Condo returns*	Boardwalk returns
2008-10 (3 yrs)	21.6%	27.1%	-31.7%	8.4%
2009-10 (2 yrs)	29.3%	22.6%	-5.2%	77.6%
2010 (1 yr)	11.3%	29.6%	-2.8%	16.3%
YTD	3.2%	11.6%	0.8%	15.5%

*For the condo, this represents the change in the equity investment of the unit assuming a 60% loan-to-value (LTV).

Source: Bloomberg, CMHC, Royal LePage, Macquarie Research, April 2011