



## STEP 1 - PROPERTY TYPES & RETURNS

Finance & Property  
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Typical yields from differing property types are provided by us on request. When reviewing your investment objectives in **Step 2**, determine whether you wish to invest in existing property (long term) or development property (short term).

Understand the different measures of return. This is extremely important.

It is unwise to assume that any real estate acquired at market value or perhaps less, will necessarily constitute a good investment.

### Types of Yields and Returns referred to

Returns normally quoted are before interest and tax to equate with yields or capitalisation rates (Cap rates) often quoted by Valuers, Agents, Analysts etc. They are not Internal Rates of Return (IRR) or Equivalent Annual Returns as quoted in our models herein. The latter incorporate entry and exit costs, varying cash flows including periodic negative income and many other factors that do not amount to Initial Yield or Cap Rates.

With development properties we quote the margin on development costs (MDC) (or profit and risk factor) also expressed as a % as well as annualised rates to give a comparison on annual return.

With feasibility models, it is better to quote after tax, after loans rates, when analysing existing property otherwise the rates do not reflect depreciation advantages of some properties over others, or the tax benefits of gearing. These factors can have a big bearing on financial gain.

**We believe it is better to quote these as a percentage return on equity. After all, this is all the investor outlays, and this is different to the return on the total project excluding equity considerations. This is not the initial yield or capitalisation rate which is a multiplier used for valuation purposes.**

The **Internal Rate of Return (IRR)** explanation is set out at the end of this section and will assist in the understanding of how your return on equity is calculated.

### **1. RESIDENTIAL**

Comments here refer to standard investment property only.

They do not refer to time-share residential, retirement village residential, or the family home.

Residential investment property is the most popular form of investment for the smaller operator in the real estate area. The investor feels familiar with the property and the concept, and this is the market that many tend to concentrate on.

To some extent, the annual trading return depends on the price bracket. At the very lowest price end the annual trading returns are higher, and at the very highest end the annual trading return is lower.

The other form of residential investment is a block of flats. The majority of existing buildings that can be converted to strata title, have been converted. The remaining blocks of flats, which can be converted and sold off, constitute more of a subdivision principal and are discussed in that section.

Suffice to say that some of the older blocks of flats which can be bought in one line and rented, need to be very carefully looked at in the long term.

### **1.1 Serviced Apartments**

These have been forecast by some industry professionals to be the new replacement residential facility for some motels, in certain classifications.

Generally speaking they have a fixed period prior to reverting to the owner, say 5 or 10 years, and are managed by the vendor. They also sometimes have rental guarantees and almost always have their furniture package included.

Some of the unknowns associated with these are the exit value for residential purposes in the future.

Because the packages and terms are very variable, it is unwise to quote a rate of return.

However it is preferable to obtain all the raw data then put it through the same model, which is being used for comparisons of other property such as the model used by ourselves. This often produces different results to those promoted by some sales people.

### **1.2 Resorts**

These are similar to the above, but are zoned specifically for resort usage and not long term “permanent” residential usage.

As per above, they often have rental guarantees. Some of these resorts, whilst you have title to your own property, are in very large developments.

Typically, the most attractive units have been sold off the plan prior to public exhibition or very soon thereafter, to previous investors, associates of the directors, and the like.

One of the dangers with these investments is that the value is largely in the hands of the management of the overall project (whose financial position is unknown) and is therefore very management dependent.

Once again the yields are very variable but even more so in these instances where they are promoted by the use of projected budgeted and taxation advantage pamphlets etc.

It is far better to compare like with like by extracting the adjusted raw data and putting it through the same model as your other investment comparisons.

## **2. COMMERCIAL & RETAIL**

This includes offices and retail, which are very often combined. Many of these developments have ground floor shopping arcades or complexes, with an upstairs residential and commercial office development, more commonly the latter. These provide a good variety of tenancy mix and get into the much higher return on capital.

The major fear for commercial investors, particularly the small investor, is the problem created by vacancies. For example if you only have sufficient funds to buy one shop, there are periods where the vacancy period can be quite extended and this can strain the resources or reduce the overall yield.



### **3. INDUSTRIAL**

An industrial investment contains the same fears for the small investor as those outlined above.

Industrial investment generally falls into two categories.

#### **3.1 General Purpose**

These are typically open span high clearance shedding type facilities which are versatile and offer possibly a great degree of internal subdivision, should this be required in future years.

The initial yields on these properties are typically in the 8%-9% bracket before tax/ loans, and could be single or multi-tenanted properties.

#### **3.2 Heavy or Special Industrial**

These properties are either purpose built, and because of this and the alternate use risk, they often achieve a higher return.

They could involve say, an abattoir or a winery held by a trust which is leased to a management company who operate the business internally.

It is difficult to generalise on the return and risks associated with this and the key factors are generally the strength of the tenant and the term of the lease.

For example, if you had a large industrial concrete complex leased to CSR for a 20 year term, you would accept a lower return than, say an abattoir leased to a smaller meat operator, which would require a very high return, probably double.

These require very careful investigation by a professional analyst or valuer who specialize in this field.

### **4. VACANT LAND**

We are referring here to developed residential, industrial or commercial land.

Generally speaking vacant land is not income producing and therefore the total emphasis for a return is through capital gain. As this is speculative, it can only form a very small part of a property portfolio and is better suited to those investors which relate to the development or riskier projects.

As a general rule, the investment in vacant residential land is not an economic proposition. The indexed cost, plus holding costs, when summated, usually exceeds the exit price.

### **5. SUBDIVISION**

There are many forms of subdivision, and generally speaking this is a specialised area best left to those with a good track record, or alternatively joint venture with an established developer. We can facilitate this.



One of the problems with some subdivisions is that many project builders often use the vacant land as a vehicle to sell their main product – the building thereon. This means they are prepared to accept a small margin over break even costs on the land which puts pressure on the specialist sub divider who requires a much higher margin for risk.

In addition to the above housing category, basically subdivisions fall into 4 broad categories:-

### **5.1 Rural Subdivision**

The sale of subdivided lots to neighbours or urban based buyers has occurred in the past.

The future may see urban based buyers leasing their land to a management company, whereby that company runs the aggregated land as one unit, with say one herd of cattle.

### **5.2 Rural/Residential Subdivision**

More often than not this is land which is former farming land and has been cut up into hobby farms or small rural residential blocks. Traditionally the winners in this area have been farmers who have used it as a profit mechanism following the fortuitous change in zoning.

This still falls into the same risk category as a development and is not advised as a mainstream investment activity, unless it is being handled by a specialist. Existing farmers already own land and therefore do not build in a factor for risk. Therefore they are very hard to compete against.

### **5.3 Duplex & Strata Plan Subdivisions**

The subdivision of existing dwellings or flats into strata plans and the subsequent sale or leasing thereof is always a possibility that is becoming less common due to the fact that the opportunities have been around for such a long time that many of the attractive properties have already been subdivided. Some still exist but expert advice from Surveyors etc. is essential.

### **5.4 Battleaxe Block Subdivision**

It is quite common, with the appropriate zoning, for people to acquire larger blocks of land with the intention of completing a residential development at the rear section. Once again this falls into the category of development risk and it is not uncommon for the smaller developments to attract a suitable margin on development costs.

## **6. RURAL LAND – Larger Scale Property**

This requires the operation of a business and is management dependant. This can be very profitable in the long term but requires a sale at the end of the period to recoup capital gain. The latter can often be 3 times the annual trading profit percentage. This is discussed in detail under **“RURAL”** on this site, where a link leads to an article by Dr. Chris Eaves. This sets out why rural property investment capital returns are higher than Commercial and Industrial capital returns.

## **7. BUSINESS PROPERTY**

This is basically real estate which is property based and has a business carried on within the premises which is obviously management dependent.



This management dependency is a big danger for such properties whether they are owned and managed or whether they are leased. Many people would be familiar with the diminution in value associated with poorly performing lessees in hotels and motels.

Therefore, the purchase of the freehold with a view to leasing the business, can be risky. Investors need a good knowledge of the industry, and need to constantly monitor the business.

### **7.1 Hotels**

We exclude here interests in large multi-storey city hotels, which are difficult to access for the small investor, unless it is through a listed trust, and this is discussed elsewhere. However, generally speaking, hotel initial yields fall within the following categories.

Small Inland Towns	}	Refer to this office for contact points with specialists
Coastal Towns		
Regional City		
City		

### **7.2 Motels**

These can vary significantly, depending on location and type.

### **7.3 Caravan Parks**

There are various categories of caravan parks and part of the investment attraction on the coast is for a change of use or zoning further into the future.

Once again the management dependency makes for significant risk.

### **7.4 Residential Villages**

These contain manufactured portable homes.

## **Where to Go?**

The old catch cry of location, location, location whilst it is important, is certainly not the determining factor. This should be replaced with:-

- ◆ Research
- ◆ Timeliness
- ◆ Structuring a Vehicle
- ◆ Financing & Taxation
- ◆ Risk Management

## **Real Estate Facts**

- Australians prefer to live and work near the coastal waterfront. Therefore they get as close to that as they can afford, given the employment choice that is available.



- Rentals and Retailing are driven by real productivity, manufacturing, employment, the creation of solid businesses and high net worth investors. Retailing and rental real estate does not in itself create productivity; it is a consumer of productivity/wealth.
- The overflow of Sydney wealth into investment real estate occurs more within roughly 3 hours drive from Sydney, particularly northwards.
- People who have a recorded history of forecasting the peaks and troughs in property values are never publicly identified, if in fact they exist.
- We have researched the best areas for residential investment based on historical rental and capital growth records.

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## IRR EXPLAINED

By **Dr. Ian Hopkins, Director of Research**

### Property Investment Research

‘Internal Rate of Return’ – a term to strike fear in the hearts of many a tough (and successful) businessmen. It’s built its own mystique while becoming a part of everyday language. It’s used by many who don’t really understand it while hoping like crazy no-one will ask them to explain it. (If you’re one of these then take this article home so your colleagues can’t see you reading it).

This article points out how simple the concept of ‘Internal Rate of Return’ or IRR is. The easiest way to do this is by example.

Suppose you invest a dollar today and get back \$1.10 in a year’s time. What’s your rate of return or your ‘Internal Rate of Return’? You’re right, it’s 10%.

Now what if you invest your dollar at 10% per year for three years? You get 10c dividend each year plus your original 100c returned at the end of the third year. Let’s put that scenario into an income stream:

	Invest	End year 1	End year 2	End year 3	Total
Cash flow	-100c	10c	10c	110c	30c

*To take this further, we now introduce the idea of Discount Rate. This is a measure of how much more you prefer money now rather than later – say in a year or two.*

If you’re prepared to accept a 10% return, that means you’re equally happy with 100c now or 110c after one year. Or 100c now and 121c in two years. In other words, 110c after one year has a present value to you of 100c. Or, 121c at the end of two years has a present value of 100c.



It also means that you would be equally happy with 10c after one year and 9.09c now since 9.09c invested at 10% will yield 10c in one year (9.09 plus 10% equals 10c). Similarly, 8.265c in two years has a *present value* of 10c now.

Lets apply these figures to our cash flow and look at our scenario in terms of present values (bottom row of table below).

	Invest	End year 1	End year 2	End year 3	Total
Cash flow	-100c	10c	10c	110c	30c
Present value	-100c	9.090c	8.265c	82.645c	0c

You will notice that the present values add to zero. This means that your internal rate of return is 10%.

**Internal Rate of Return is the discount rate at which the present value of all cash flows total to zero.**

Yes, that's all it is! The IRR tells you how hard your money is working for you over the period of the investment.

Let's go over what we have just discussed. We took the first year's cash flow and divided it by 1.1 (i.e, 1 + 10%) to get its present value. We took the second year's cash flow and divided it by 1.1<sup>2</sup> to get its present value. And we divided the third year's cash flow by 1.1<sup>3</sup> to get its present value.

We then added all the present values together to get zero.

Note that we could have used dollars, thousands of dollars or percentages instead of cents in the cash flow and still got the same IRR.

Now for another scenario you wouldn't bother working out by hand i.e. without Microsoft EXCEL or equivalent.

	<i>End of Year</i>							
Invest	1	2	3	4	5	6	7	8
-100c	5c	-4c	34c	6c	13c	-19c	7c	147c

What's the internal rate of return here? This one's much harder to work out because the income flow is variable and, at the end of years 2 and 6, the managers have asked you to tip in 4 and 19 cents per unit.



But the answer is that the IRR is again 10%. In other words the above scenario results in the same IRR as the one below, for which the IRR is (rather more obviously) 10%.

<i><b>End of Year</b></i>								
Invest	1	2	3	4	5	6	7	8
-100c	10c	10c	10c	10c	10c	10c	10c	10c

In Microsoft Excel:

For the example above with the varied cashflows, in a cell, type:

=IRR(C1:C9) <return>

where C1 = the initial investment (-100) and C9 = the final cash flow (147). Using the “:” notation in the middle means all the other cashflows between the first and the last will also be included.

If you’re still with us you’re way ahead of a lot of others. For a more in-depth understanding read on.

When we incur costs or make our initial investment our cash flow is negative. These negative figures are discounted in the same way as the positives. So we end up with present values for negative cash flow years and present values for positive cash flow years.

*When the present value (‘PV’) for the positive cash flow years is the same as the PV from the negative cash flow years, the discount rate used is the Internal Rate of Return.*

Example again (in a different form):

<i><b>End of year</b></i>										
	Invest	1	2	3	4	5	6	7	8	Total PVs
All cash flows	-100	5	-4	34	6	13	-19	7	147	
Positive cash flows		5		34	6	13		7	147	
PV of positive cash flows		4.55		25.54	4.10	8.07		3.59	68.58	114
Negative cash flows	-100		-4				-19			
PV of negative cash flows	-100		-3.31				-10.73			-114



In practice the computer works out the IRR by randomly selecting an IRR figure, say 8%, and calculating a PV which (in the above case) is positive. It then repeats this process with different discount rates until it finds the discount rate which gives a PV of zero. It can do this in a fraction of a second where it would take you or I hours to work out.

A present value that incorporates negative returns as well as positive returns, as in this example, is sometimes called *Net Present Value* or *NPV*.

### **Why is the IRR important?**

*The IRR is important because it tells you exactly how hard your money is working for you. It is not misleading like many other measures of rate of return.*

*Let's illustrate how an alternative such as the 'average rate of return' can be extremely misleading. In the first example below, the average rate of return p.a. over the investment period is 28.8% i.e.  $(0+0+20+20+40+40+50+60)/8$ . But in the second example it is only 22.5%. Yet the Internal Rate of Return is higher in the second example than in the first (25% versus 20%). Funds invested are working harder in the second example. The reason is that the bulk of returns are received earlier.*

*Even more misleading is when prospectuses report an average rate of return for only part of an investment's life. In the first example some prospectuses might state the average rate of return p.a. after the second year is 38.3%  $(20+20+40+40+50+60)/6$ !!! This is a way of excluding the zero cash flows from years 1 and 2 in an attempt to improve the appearance of returns.*

Invest	End of year								IRR	Ave. rate of return p.a.	Ave. rate of return p.a. (after 2 <sup>nd</sup> yr)
	1	2	3	4	5	6	7	8			
-100	0	0	20	20	40	40	50	160	20%	28.8%	38.3%
-100	30	30	25	20	20	20	15	120	25%	22.5%	20.0%

*In the extreme example, the rate of return in some timber plantation investments is very high in year 25 when trees are harvested. But there is no income in the first 24 years! An IRR is essential to get a real perspective on rate of return.*

*What this shows is that returns in the early years are more important to IRRs than returns in later years.*

*So beware of investments which show high rates of return in later years and publish these figures (and not IRRs) in prospectuses. Always use the IRR for the most accurate indication of return.*

***IRRs will tell you exactly how hard your money is working for you irrespective of the pattern of income distributions over time. No other measure of return will do this.***

