



STEP 2 – INVESTMENT OBJECTIVES

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Defining the Purpose and Risk Category

Before any property is purchased, the buyer should thoroughly think through the purpose of the investment. This is because property is essentially a long term investment, with entry and exit costs capable of creating a capital loss if the investment is sold early. This section addresses direct property investment only.

Financial and property advisors/consultants need to know what the investment objectives are, and these (amongst others) could include:-

- **Retiree (Maximum Yield Priority)**
After commencing retirement, this could be purely yield based, to provide immediate maximum personal income and, disregarding the future estate beneficiaries' interests.
- **Retiree (Capital Growth Priority)**
As above, but reduced yield and a component of growth for future estate beneficiaries.
- **Limited Term Investment (Geared)**
Where the maximum terminal result is planned to roll into another investment. This could involve negative gearing where there is no direct disposable cash surplus except for tax savings.
- **Limited Term Investment (Ung geared)**
Where there could be single tenancy risk and no fixed financial commitment is desired, or where a maximum cash surplus is required for use elsewhere.

The other important issue is to determine what risk category suits the investors personality and financial position. This will determine the choice of **Development** versus **Existing Property Investments**.

Development

We exclude here any construction where the initial intent is to enter into a previously agreed long-term lease. This situation is merely an option where suitable existing premises are unavailable or too expensive. For the purpose of this section we refer to any uncontracted development, which is dependent on attracting future buyers/tenants.

The returns here are much higher (at least double) but obviously in this scenario the risks are greater.

If the investment is syndicated to access otherwise inaccessible projects, we strongly recommend you consider the use of equity rather than debt with developments. Equity partners will wait for returns or share the loss – Bank's won't!

If debt finance is used investors should place themselves in a position where this can be paid out without forcing a sale of the property through:-

- New Equity Partners (Rescue package)
- Previously arranged second mortgages (possibly undrawn) or subordinated debt (possibly incurring a commitment fee)
- External borrowings on other existing security to pay out the debt.

Approaches to refinance the debt through another Bank are rarely successful in forced circumstances.

Existing Property

This usually offers less risk and appeals to those who are risk averse.

There are various ways and theories of measuring risk but suffice to say that the investor should consider the returns and risks (in their own minds) to confirm what part of the risk/return spectrum they are considering. Generally the higher the return, the higher the risk.

Components of Financial Gain

There are several components of the overall financial gain in property investments. e.g.

- (a) Taxation savings
- (b) Present Value of the current income
- (c) Present Value of the future income growth above *CPI*
- (d) Growth in Value on resale (above indexed cost base)

It is mathematically possible to calculate these components and it is only worthwhile doing so to identify risk.

Property analysts call this Component Analysis.

For example if a property is showing an internal rate of return of 10% before tax etc. we can say for example, by taking the present value based on the current rental, that say, 50% of the 10% IRR is due to current known returns, and the balance is based on growth.

Growth

The term “real growth” is that increase over and above the projected *CPI*.

Assumptions on growth are speculative and are often contained in real estate sales models.

Most investors place more emphasis on the present capitalised value based on the current rental, than that reflected in future value based on the growth in rental.

Therefore there would be a need for closer scrutiny if a high % of the IRR was comprised of growth, to see what underpins the assumptions. What evidence is there to support this?

The use of sensitivity tables to identify risk areas is discussed elsewhere.



Similarly a return based largely on tax benefits would also flag a need to see if these tax laws are likely to be reviewed. Depreciation benefits may for example be a safer bet than say periodic vote winning legislative changes or incentives.

Our computer model can switch the tax assumptions on and off to determine what % of the total return or IRR is based on tax benefits.

