WHAT WILL THE NEXT BUYER PAY? THE KEY TO INVESTING IN PROPERTY

By Terry Boyd, Professor of Property Economics, QUT

Most investors look at the initial return (or yield) that they will receive from an investment property, but this is only part of the picture. The more important issue is what capital appreciation will be achieved. Unless an investment property will deliver substantial capital appreciation, it is unlikely to be a good investment in financial terms.

An investment in real property is no different from other investments; it should provide a better return than alternative investments with similar levels of risk. The risk/return trade-off can't be ignored. Investments have very different levels of risk. As an example, a well-leased property with reliable tenants should command a different yield rate to a vacant property with a history of 'unlets'.

What is an acceptable return from a residential investment property?
Let's answer this question by looking at some perceived rules of thumb on investing in residential property and the returns obtainable from other investments.

Firstly, one rule of thumb is that a residential property should achieve *$1 rent per month for every $1,000 invested*. Does this provide guidance for a good investment? The answer is "no". What this rule suggests is that a rental property costing $250,000 should achieve a rental of $250 per week in order to be worthwhile. In fact, this is a pathetically low return.

Look at the calculation of return from this investment example:

Rental income @ $250 x 52 weeks	$13,000
Vacancy allowance of one week	-250
Actual rental received (per annum)	$12,750
Landlord Expenses	
Such as rates ($2200), insurance ($500), maintenance and misc.($400)	
(NB management fees ($770) have not been included)	
Minimum expenses, say	-$3,100
Net income received by investor	$9,650
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In the exercise above, therefore, the investor receives a return of $9,650 on an outlay of $250,000, which equates to a return of **3.9% p.a**. This is a low but anticipated return as most rental properties will achieve an initial return of between 3% - 5% p.a.
Note: The complications of loan finance and taxation have been ignored at this stage, but will be discussed briefly later.

Back to the question of the amount of an acceptable return. In fact you can't say at this stage as you have only observed part of the picture. It is somewhat like predicting, at half time, the final score in a footy game. We do know that the rate of 10-year government bonds in Australia is currently around 5.6% p.a.- this is a measure of the risk-free rate of return. Also it is currently possible to invest in cash instruments at close to this figure. It follows that no knowledgeable investor would invest in rental property at a return of 5% p.a. if they can deposit their money safely in a bank and obtain the same rate of return.

Clearly the difference is the expectation of capital appreciation from investment property. Property has, generally, achieved reasonable capital appreciation in the long term. However, it has been said that *property grows at 10% p.a.* – this is an old rule of thumb. Is this a reasonable expectation?

There are certain unique types of property that will experience this compound growth rate, but it is very wrong to assume that most properties will achieve this level of capital appreciation over a long period of time. The year 2001 was a phenomenal one for residential property growth in Southeast Queensland and in many other parts of Australia, but nobody expects this growth to continue – do they? Astute investors are not blinded by just "part of the picture", they will look beyond the short term market fluctuations.

I must declare my own concern about statistics at this stage. If you are selective enough about what statistics you use, you can prove anything! Property can be shown to have very poor returns in relation to shares and cash instruments, or conversely, it can be shown to outstrip all other investments and double in value in three years. Be very cautious about placing too much faith in statistics, they can and do deceive.

So, what return should be expected from residential property? If we go back to the supposition that the income return you will receive is in the order of 3% - 5% per annum, then there should be added to this figure an annual capital appreciation of approximately 7%. This would provide a total return - on income and capital – of around 11% per annum, say 10% - 12%. I suggest that this is a reasonable guide for an acceptable return from rental property over an investment period of, say, 10 years.

Why have I selected this particular range? Because the rate of return must relate the rate from other investments. Let's examine the achievable returns from other investments. As mentioned earlier, the current risk-free rate is approximately 5.6% per annum, and cash instruments with very little risk are around this figure. There are several short-term cash investments, with varying levels of risk, at returns of 6% to 10% per annum. Nexus bonds are currently being offered at 10.25% per annum for five years (as at 6.11.02).

Then there are indirect investments in property, such as investing in the listed property trust sector on the Australian Stock Exchange (ASX). These investments have recently shown returns in excess of 10% per annum, but are expected to give returns of up to 10% per annum in the medium term. They will be strongly influenced by changes in the ASX in the years ahead. At the other end of the scale, the investments that are more risky than residential property investments are shares on the ASX. You should expect an overall

return from shares of well in excess of 10% per annum over the longer term. Investors entering the stock market at this time are looking at long term trends and are, probably, not too concerned about short term fluctuations.

I therefore suggest that rental property investments should achieve a greater than 10% per annum return if they are to prove worthwhile. Not all rental property will achieve this target, and it is the properties that will experience above average capital growth in the future that will be successful.

This is why it is essential to examine the demand for the property by the next buyer. The property must be more attractive to the future buyer than it is at present. This means you should focus on ensuring that the product you have is not able to be replicated at an equal or lower cost and that you are able to enhance the value of the property. Location plays an important role in ensuring capital appreciation, but, contrary to popular thought, it is not the only characteristic that you should examine. The quality of the improvements on the property is also an important factor.

What about the effect of loan finance and taxation? I have heard it said that these are *the primary reasons for investing in property*. I strongly disagree. You should make use of loan finance and the short term tax benefits that may arise from a property investment, but they should not be the main reasons for investing in property.

Space does not permit a detailed examination of these factors, but don't be misled by overrating the tax reductions on other income to the detriment of your property investment. Negative gearing is not beneficial in the long term. A breakeven situation is a far better option. Furthermore, remember it is not a good investment unless you get strong capital appreciation, but capital appreciation attracts capital gains tax, and a possible write back of the earlier tax benefits. Hence tax has more negative than positive effects on property investments. Loan finance brings another risk into the investment, and, if well managed, can be helpful, but you should always consider the effects of a market downturn on the investment. A good strategy is "never buy an investment property for its tax benefits alone".

Investing in property can be extremely rewarding provided you are immersed in the property market and understand the investment process well. At QUT we have developed practical courses on property investment that are aimed at the property professional and the investor. There are two certificate courses available online that may serve as bridging programs for entry to postgraduate courses. This allows professionals, such as property consultants, to progress to postgraduate studies in small steps, with the option to stop at any stage.

The online courses are:

> **Investing in Property (QUIP 501)** – this course expands on the contents of this short paper

Property Cash Flow Models (QUIP 502) – the professional evaluation process for major property investments

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