Yield Strategy

SACRIFICING CAPITAL GAINS IN THE PURSUIT OF MAXIMUM RENTAL INCOME.

LONG-TERM INVESTMENT STRATEGY INFO PACK

Property Investors Club
225 High Street
Christchurch CBD

Phone: 0800 943 534
email@propertyclub.co.nz
www.propertyclub.co.nz

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NB: This is provided as general information only and does not represent personal advice pertaining to your own unique circumstances. All the numbers and examples provided assume 100% borrowing on all investments, with interest only mortgage repayments. If you pay any cash towards an investment or pay down loan principal your results would be more favourable, however it is not advisable from a tax perspective to pay principle on an investment mortgage while you have a home mortgage.

The "Buy & Hold" strategy.

There are several different strategies that you can implement to prosper in property investment. No single method is the best for everyone, but one is probably best for you.

The buy & hold strategy is the most popular method, possibly due to the low risk relative to potential reward. It simply says you will purchase a property with a view to making capital gains over a long period of time, by the value of that property increasing and/or rental income, but there is more than one way to do that.

This strategy is the least time consuming, hands-off approach to investing, as opposed to property flipping, which requires significant time invested into finding, renovating and selling properties regularly. It can be quite literally, set and forget, so is ideal for working people who want a nest-egg for retirement or a passive income.

We categorise the buy & hold strategy at three levels:

GROWTH FOCUSED
Disregarding rental income in the pursuit of maximum capital gains.

YIELD FOCUSED
Sacrificing capital gains in the pursuit of maximum rental income.

BALANCED
Choosing a property to provide a balanced level of both capital gains and rental income.

Risk.

With risk can come great rewards, but also the potential for loss. No matter what you choose to invest in, there is risk and reward to consider. It's a balancing act.

Property is a low-risk, high reward investment category, but is not immune from failure. The risk matrix below shows how Property (as a whole) performs against other asset classes, but property has a risk matrix of its own, with several variables which this document will guide you through, showing how different properties have different risks and profitability profiles.

We all have a different capacity for risk, so consider what your capacity is, then choose the property that will provide the best returns for you, while still feeling comfortable you haven't over exposed yourself to risk.

Risk Matrix: Asset Classes.

Risk and reward can be varied so suit most personality types and financial situations, by shifting three parameters:

1
GROWTH POTENTIAL

Relying solely on growth with total disregard for rental income is high risk.

2
YIELD

The more rent you receive each week, the less risk you are taking, but you will sacrifice growth opportunities by doing this.

3
QUALITY

Better properties, such as brand new buildings, are safer investments, but more expensive.

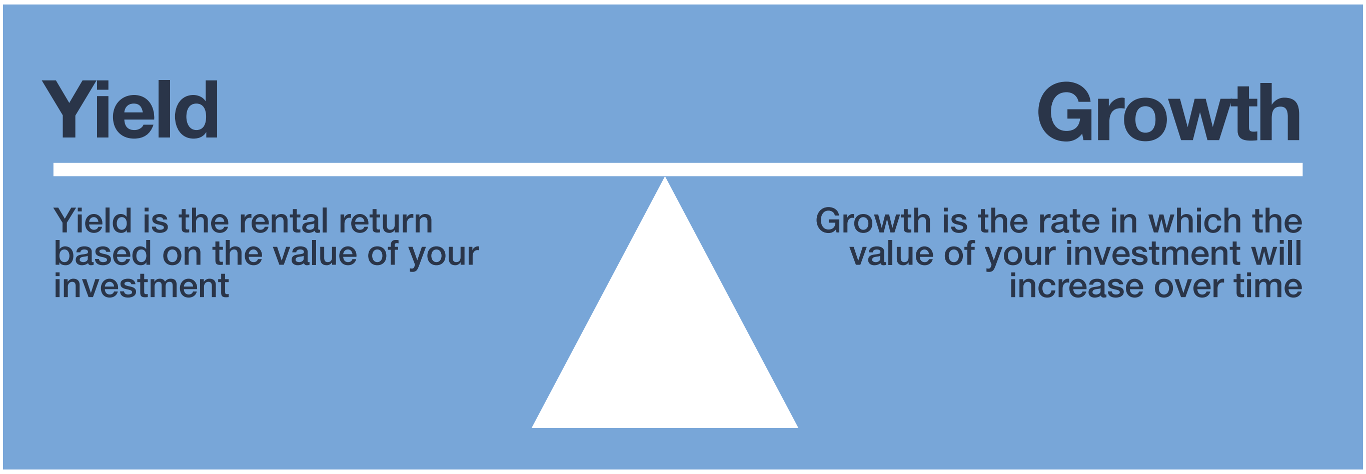
Rental approach.

Due to the economic nature of the property market, capital gain potential (growth) comes at a cost to rental income (yield), and vice versa, so taking a strategy which focuses on acquiring property with maximum rental potential usually means you'll enjoy a positive cash flow week to week, but will probably not experience capital gains as much as other investors who have a more growth focused approach.

In a nutshell, a yield focused investor will acquire properties that give them the best rental income relative to their purchase price, which usually means purchasing in cheaper areas and/or higher density dwellings.

Capital gains typically provide a superior financial benefit overall, compared to what can be achieved from rental income, so a rent focused approach makes sense for investors with no disposable cash, a very low appetite for risk, or both.

Benefits of this strategy	Negatives to consider
Positive cash flow	Less long-term profit
Low risk	



Yield vs Growth.

When you invest in property there are really only two things you're looking for. Capital gains and rental income - preferably as much as possible.

As investors, we measure capital gains in terms of 'growth'. Rent is measured in terms of 'yield'.

Growth is considered most profitable, due to the long history of property values increasing, but also carries the most risk - if your property doesn't increase in value, you've gained nothing.

Yield, on the other hand, helps to pay your expenses, and minimises your risk - If your property doesn't increase in value, but you've been pulling in good rent, you've still made a gain.

It's generally accepted that when you are choosing a property, higher growth will come at a cost of lower yield and vice versa. They're both on the same spectrum, so it's not like you get one and not the other - It's just a question of scale.

It happens that way because it's land that gives you growth and buildings which give you a yield. Land goes up in value, but people aren't lining up to rent a bare piece of land. Meanwhile, buildings can actually depreciate, but that's what your tenant is going to be paying you for.

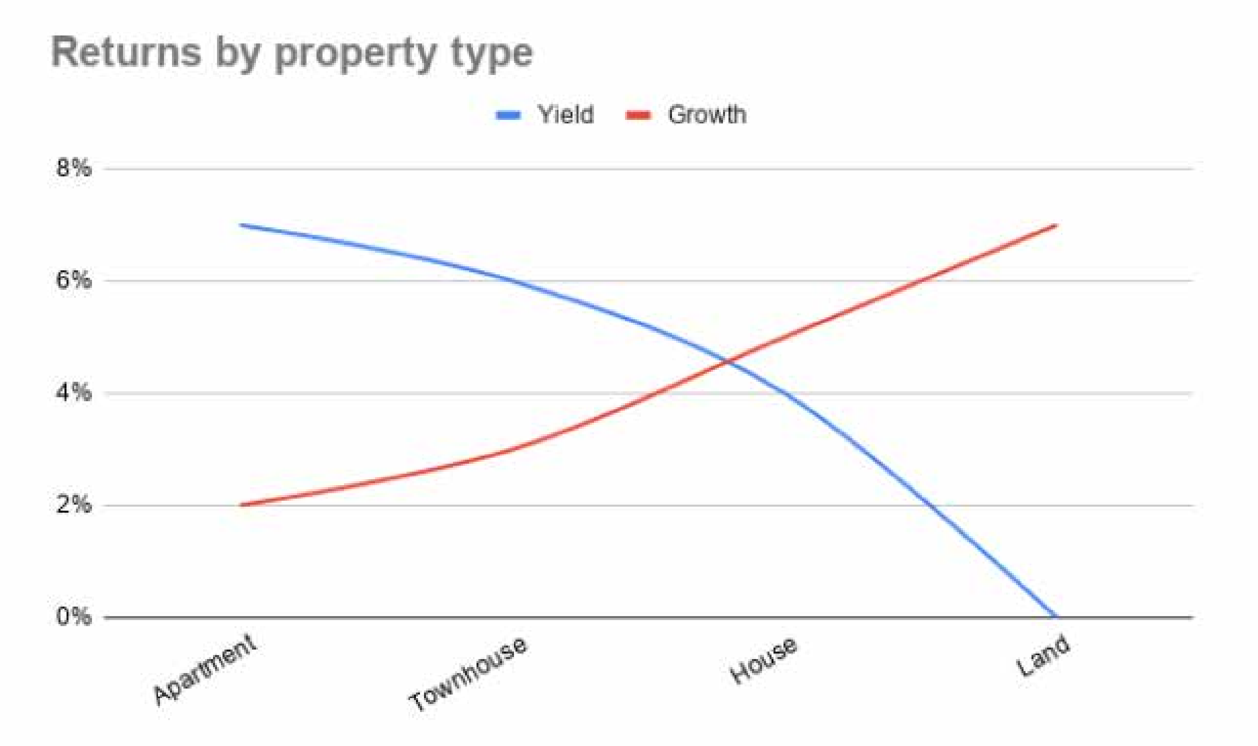
So when you're out shopping for a property, whatever your budget, some of your money goes to land, and the rest into the building. Your land budget will always come at a cost to your building, so your growth will always come at a cost to your yield.

MAXIMISING YIELD

The yield you get from your property investment is your decision to make, based on what you buy and where. Given a purchase budget of any size, a yield investor will attribute as much of that budget as possible to income generating assets; the least being available for land.

Property Type.

We categorize property into four types - apartments, townhouses, houses and land - written in this order which illustrates the size of the land each type has, relative to the size of the dwelling. The more land, the more growth you can expect, but lower yield.



Below is an example of what your forecast might look like comparing an apartment with a house:

The numbers - 10 Year comparison		
Info	**Apartment**	**House**
Initial value	$500,000	$500,000
Weekly cash flow	$50 income	$50 expense
Growth rate	2.50%	5.0%
Growth after 10 years	$140,000	$314,000
Cash profit (loss)	$26,000	($26,000)
Total profit	$166,000	$288,000

APARTMENTS

Apartments are built on ‘strata’ titles, normally one above another, meaning that you don’t own a particular piece of land. Instead, you own a share of the underlying land parcel, jointly with all the other apartment owners. There are also common areas and rules controlled by a body corporate, which you contribute regular payments towards.

Apartments don’t increase in value much but because they are the cheapest type of property to buy. With relatively high rental returns, but they provide a great yield. Apartments, particularly older ones, are a great option for yield focused investors who don’t require capital gains.

TOWNHOUSES

Townhouses are often built in blocks whereby neighbouring properties share a wall, but they have a clearly defined plot of land which is owned individually. They have some common areas which owners are jointly liable to maintain, sometimes by way of a body corporate or residents agreement.

Often you can find affordable townhouses in premium areas because they have only a small plot of land, meaning they can provide a good capital gain and rental return, and should definitely be considered for a balanced yield strategy if you are merely seeking a neutral cash return but ultimately still want good growth.

HOUSES

We all know what a house is - A typical Kiwi home, standalone on it’s own plot of land. Houses appeal to both investors and owner occupiers, so are easiest to sell when you come to the end of your investment journey.

Houses have larger plots of land, so enjoy great growth potential, but expect to forgo some money week to week.

LAND

Bare land is not actually a viable solution for a yield investment strategy but it does help to illustrate the economic principle of the strategy by showing the extreme end of the scale between yield and growth and how that relates to land size. When you invest 100% in land you invest 100% in an appreciating asset, but will get 0% return on rent.

Location.

Though it's popular to buy a rental property close to home, exploring opportunities beyond the town or city you live in is a worthwhile exercise.

There are a few rules to consider when comparing different towns and cities:

Smaller towns usually rely on one main industry to support the economy and employment. This makes them prone to Boom or Bust property values. Queenstown, for example, relies almost solely on tourism. Values skyrocketed on the back of a rise in visitor numbers from 1.6 million in 1999 to 3.9 million in 2019. Then Coronavirus hit.

More expensive cities, like Auckland, are expected to rise in value at a faster pace than less expensive cities. This is probably why they are more expensive.

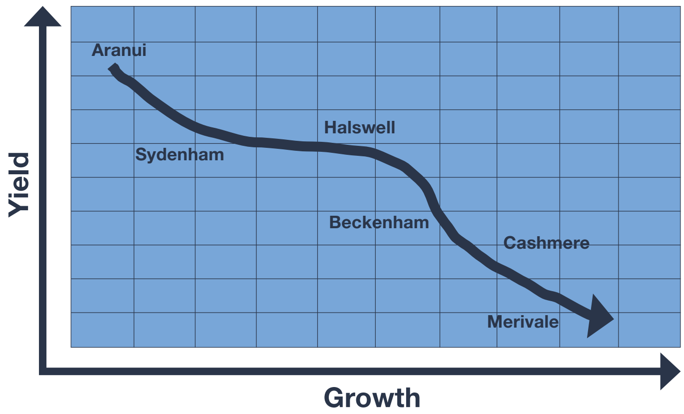
More affordable cities, like Invercargill, have higher rents relative to purchase prices, but are not likely to enjoy capital gains to the same level as Auckland.

Christchurch is a unique market.

Compared to historic trends, purchase prices are well below the national average, rental prices are high, and all other market indicators are strong, suggesting it is quite possibly the best of three worlds:

Growth potential: Good
Rental yields: High
Economy: Robust

The interesting thing about rent is that it doesn't vary much between suburbs. The same house in Merivale for example, might only earn $80 more each week, but cost twice as much to buy, compared to say, Aranui, so to increase yield, given the same property type, you can shift from an expensive neighbourhood to a cheaper one. For example, if you are set on wanting a townhouse, but aren't satisfied with the yield of the property, you can increase the yield by finding a similar townhouse in a cheaper neighbourhood. Because the purchase price is likely to be less, but rental income would be similar, your yield will increase. Normal rules apply though - expect less growth.



Other ways to increase yield

There are things you can do to increase your yield, while not adversely affecting your growth potential.

Decrease dwelling size Smaller homes will cost you less to buy but rental income will not be affected much, provided the core ingredients of the home are still present.

Increase bedroom numbers Compare a 3 bed home to a 4 bed home. With all else remaining constant, the 4 bed will give you a better rental yield.

Tenancy types Multiple tenancies within a single dwelling can increase yield. This can be done by either renting on a room by room basis, or renovating to divide a dwelling into multiple self contained units.

Building Quality.

Another thing to consider is whether you will want to purchase brand new or older. There are pros and cons for both. Assuming all else is consistent, you'll be able to find older property cheaper than brand new, but new is considered a safer option with better rent potential.

Brand new property

Brand new property is most commonly bought 'off-plan', meaning you agree to buy it prior to construction. Of course, there are plenty of brand new properties available that are complete already, but you'll usually find these selling for a premium price.

The best part of buying off-plan is that the sellers are usually up front about their price expectation, compared to sellers of existing properties who prefer negotiations, auctions or deadline sales.

Since the canterbury earthquakes, building standards have been raised dramatically, with engineered foundation design and ground remediation commonplace. For this reason it is logical to expect properties built post 2011 to always hold a premium resale value as buyers are wary of the earthquake history, substandard structural integrity and botched repairs.

Modern properties are well insulated, double glazed and efficiently heated, making them a comfortable and economical place to live, as well as meeting the minimum legal requirements of healthy homes standards recently introduced for rental properties.

Brand new property is in high demand for tenants, so you can charge a premium rent and expect less vacancy, but do be aware that your gross yield (rent compared to purchase price) will be lower, and your purchase price higher.

Older property

The obvious benefit of buying older property is that you can find much cheaper options, and still expect rental income close to the level of a new property. That means a higher gross yield.

Being cheaper and dated, this can provide an opportunity to renovate and add value. Renovations cost money, but if you find the right property and don't over capitalise on your improvements, you can create additional equity in the property, if you strike the right balance.

Most investors who buy older properties choose those which are made from permanent materials i.e. aluminium window frames and brick cladding, to minimise their future maintenance costs. Nothing lasts forever, so you'll obviously need to replace things from time to time, but this is a good step in the right direction.

Avoid plaster clad properties built in the 1990s, as they are prone to weather tightness issues (leaky homes). Even a property of this nature which is actually watertight and has no signs of moisture damage will be tainted by the perception of leaky home syndrome, so could be difficult to sell in the future.

Building Quality.

While the extra price can seem a lot at the time of purchase, based on actual cash outgoings it is almost the same price to own a brand new place compared to an older one of a similar size and spec. If you were to quantify higher maintenance and vacancy costs, you might discover a new property is actually cheaper. While brand new property costs more, it's also worth more.

	BRAND NEW PROPERTY	OLD PROPERTY
Purchase price	$500,000	$450,000
Mortgage cost at 4%	$40 more per week	$40 less per week
Rent	$500 per week	$480 per week
Cash difference	+$20	-$20
	BENEFITS	BENEFITS
	Less maintenance cost/risk	Potential to add value
	Better choice of tenants	Higher yield
	Built to modern code	Available now (built)
	Better property	
	Fixed price	

Risk Matrix: Building Quality.

CASE STUDY

Central City Apartment.

Brenda and Steve were approaching retirement. They had a freehold home and $100,000 cash in the bank, but they weren't getting much of an interest return on their money these days, so decided to buy a property which would give them a good weekly rent to supplement their superannuation.

They found a central city apartment in Wellington, with a single bedroom and bathroom, which cost them $330,000, of which the bank loaned them $230,000.

These are our assumptions:	
Purchase an investment property worth	**$330,000**
With a cash deposit of	**$100,000**
We expect capital gains at a rate of	**2.50%**
The average interest rate over 10 years will be	**4.39%**
Rents and expenses increase at a rate of	**3%**
We assume a rate of vacancy at	**5%**
Rent appraisal is	**$380.00**

This is what we've calculated:	
Gross yield year one	**5.99%**
Net yield year one	**3.76%**
By year ten you will have made	**$219,521.34**
You'll have gained this much equity	**$178,624.78**
Over the 10 year period your total cash flow will be	**$40,896.56**
That will be a weekly average profit of	**$78.65**

CASE STUDY

Old 4-Bedroom House.

Kelly & Dylan had a moderate household income but with a baby on the way and facing a reduced income they were conscious of finding an investment that didn't put any additional pressure on their week to week cash flow.

They liked the idea of owning a house and land, but ultimately needed to maximise their rental return to avoid negative gearing, so found an old 4 bedroom house in one of the cheapest neighbourhoods.

These are our assumptions:	
Purchase an investment property worth	**$320,000**
With a cash deposit of	**$0.00**
We expect capital gains at a rate of	**3.50%**
The average interest rate over 10 years will be	**4.39%**
Rents and expenses increase at a rate of	**3%**
We assume a rate of vacancy at	**5%**
Rent appraisal is	**$420.00**

This is what we've calculated:	
Gross yield year one	**6.83%**
Net yield year one	**4.00%**
By year ten you will have made	**$117,501.55**
You'll have gained this much equity	**$112,627.15**
Over the 10 year period your total cash flow will be	**$4,874.40**
That will be a weekly average profit of	**$9.37**

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