Yield

Property Wealth System

a-z OF PROPERTY INVESTING

Y for Yield

In simple terms, a yield is the amount of money or profit produced by an investment. It has two elements to it - the original price of the investment and the money earned over a time period. The ratio between these two is the yield, often expressed as a percentage. It is a statistic that tells us something about the investment, can be used to compare one investment with another and can be used to measure against our own personal yield targets.

But as the great philosopher Homer Simpson once said, you can come up with statistics to prove anything - 40% of people know that, and for a small yellow cartoon character, he's right. Estate agents will often use gross yield to sell a house. For example: a house is up for 75,000 pounds and the market rent is 650 pounds per month. The gross yield is the amount of rent annualised, divided by the purchase price, so 650 pounds per calendar month multiplied by 12 gives 7,800 pounds. Divide that by the purchase price of 75,000 pounds, times it by 100 and you've got 10.4 percent.

In the property description, the agent might say: 'Attention investors, a whopping 10.4 yield for this property'.

But wait, firstly is 650 pounds achievable? And secondly, and more importantly, gross yield is a weak measure as it ignores transactional costs, operational costs and if you rely on an estate agent to tell you what the yield of a property is, you could end up making a bad decision.

As always, make sure you do your own due diligence.

So, what could you use instead? Net yield? Well, it's definitely better, as net yield accounts for the costs, but we all define costs in a different way. One investor may think costs are just the refurb costs, another investor may allow for the legal fees; broker fees; licensees; stamp; refurb; operating expenses - the whole shebang, and both are right. If that's what they choose, just so long as they understand what they're netting out, and they are always consistent.

I have to say, I have never used gross yield to measure a property's potential, and neither have I used net yield and that is for the simple reason that I buy property and add value to it.

So, if I spot a house that either needs some work, or it can be extended, or the use can be changed, I buy it with cash. Either my own or someone else's, and when I have added the value, I finance it at its new end value. So, yield at the date of purchase, based on purchase price, doesn't mean all that much to a property investor, because this is what you do to that property, the potential rent you can get from it and the back-end value that you can achieve, that is important.

So, can we measure a property in a different way? Yes, we can.

At the point of purchase, I like to use return on capital employed, based on what I'm going to turn the property into, when the value has been added. Return on capital employed is defined as the net income from a property, divided by the money left in the deal. It accounts for the costs, and the value that you're going to add to the property. Again, if you ask 10 investors what their costs are, they will all include different things. For me, I like to work on a net, net, net, net, net, net - well you get the picture. That means I account for all the costs: refurb; stamp; professional; transactional; cost of money; operating costs etcetera and I am consistent in using the same formula. So, when I compare property deals, it actually means something real.

Now, each investor will have their own target on the return that they are looking for, and it will depend on your goal, strategy and the time and money available to you.

Some people will be happy with the return on capital employed 25% for a buy-to-let, while others may want excess of 60 or 70%, and both investors are right. If you always work from determining your goal and strategy first, then the KPI you use will naturally flow. And remember, don't compare your return on capital employees with someone else's - you don't know how they're going to calculate their costs, and you don't know their goals and their start point. We are all on different investment paths, just focus on your own.

So, in summary, 'Y' is for yield, a term that agents like to use to attract buyers, but in reality, it is not a measure that is used very often for professional property investors because we add value to our property. Therefore, we are more interested in the future scenario, when we have added the value and refinanced the new improved property. With traditional lending, that's where return on capital employed is a more useful measure for decision making. But even my measure of return on capital employed is a snapshot in time, and I use other measures to analyse my portfolio ongoing,
but that's a whole other
tutorial series.