Module 13 : Investment Property

- What is investment property?
- Who buys investment property?
- Legal aspects of investment property
- Managing investment property

Topics covered in this module:

- What is an investment property?
- Who buys an investment property?
- Legal aspects of an investment property
- Managing an investment property
- What investment buyers look for in an agent
- CGT - Tax Implications for Buyers

Investment Property – 5m 14s

13.1 Introduction

An investment property is property that is acquired by the buyer to rent out and make a profit from.

It can be either residential or commercial property; the choice depends on the investor and what levels of risk he or she is prepared to take on.
From an estate agent's point of view, it is a very good idea to uncover property investors and build up strong relationships with them. They are very different clients to the people who buy homes to live in.

The biggest difference is that investors are always in the market to either expand their portfolio by buying property, or to upgrade their portfolio by selling what may be an under-performing asset and buying another house or commercial building that they think will enhance their investment.

Investors will also be more likely to be interested in properties that are on the market for below average prices. The reason for this is clear, the lower their initial outlay, the better their ROI or return on investment will be.

In the property investment area, there are distinct differences between investment in residential property and commercial property. These differences are mainly due to the nature of the use of the property and the length of the leases that tenants are prepared to sign.
The main differences between the two are:

  - Leases: Residential tenants will usually sign renewable leases for a year with a defined notice period of anything between one to three months. In recent years, the average length of leases has risen to about 20 months. There will be a clause stating that the rent will be escalated by a calculable amount every twelve months. Rent escalation ensures that the owner's return on investment keeps pace with inflation.

  - Commercial property leases are far longer than residential leases. It is not uncommon for leases to run for ten years or more. Security of tenure is essential for businesses, particularly if they have to install machinery and have major structural changes made to the premises to accommodate their operations.

- Residential landlords are usually liable for the maintenance of their properties. They either do the work themselves or they might appoint a property management company which will then be responsible for the maintenance. This applies to structural maintenance rather than garden and lighter maintenance such as changing light bulbs and so on. For this, there will usually be a clause in the lease stipulating that the tenant is responsible for keeping the premises neat, clean and in good order.

- Owners of commercial property are not responsible for maintenance and repair of their properties. This is usually carried out by the tenant. The reason for this is that it would be very difficult for a landlord to set the repair and maintenance schedules with the operations of the tenant who would need uninterrupted use of the property all year round. It is far more practical for the tenant to schedule maintenance and repair work for their annual shutdown.

- Commercial property costs a lot more per square foot to build and maintain than residential property. This is because the construction specifications are far higher for commercial structures as they have to withstand much heavier use than residential structures.

- The returns on residential property are derived from the increase in the capital value. The receipt of monthly rental helps cover maintenance costs and expenses such as levies and taxes, but the real payback comes when the property is put on the market. This of course is only applicable if the owner is able to time the sale of the property to their best advantage. If they have to sell because of financial problems or another matter that dictates an immediate sale, they could stand to lose money when they calculate their returns over the period they owned the property.

- The returns on commercial property are mostly derived from the income from rentals.

13.2 Commercial Property

Investment in commercial property is usually categorised into three broad sections:

- Offices
- Retail
- Industrial

These sections can in turn be divided into subsections which helps clarify matters. The reason for categorising commercial property is that the different sections attract very different sets of risks.

Industrial property caters for functions like warehousing, manufacturing and services like petrol stations, bulk gas supply and servicing of plant and machinery. The buildings are basically shells with double or triple volume structures and a section for office accommodation.

More often than not, the road access to factories and industrial parks is designed to handle heavy trucking and the properties have areas for docking and off-loading bays and handling facilities.

The power supply to industrial areas is also of a higher level than residential or office facilities.

The next category of commercial property is the retail sector. Here again, the construction specifications are far more robust than the specifications for residential buildings and the same applies to office blocks and office parks where the buildings are only one or two levels high.

For all commercial property, a lot of time and planning goes into the development of access roads and the supply and reticulation of water and electricity. The removal of waste, both sewerage and solid, also has to be factored in, as does the capture and drainage of stormwater. Building access for emergency vehicles and the provision of emergency services such as firefighting equipment all go to increase the initial cost and eventual value of commercial property.

Now, if you compare all the factors that have to be built into a commercial property project, you can imagine that the cost per square foot is a lot higher than for a housing project.
Other sectors that fall under the three main categories are:

- Hospitality and leisure, which cover restaurants, hotels, pubs and entertainment venues
- Student accommodation and hostel facilities
- Accommodation blocks such as high rise flats
- Healthcare facilities

Each of these subcategories will have special rules and regulations that apply to their health and safety planning, which will add to the cost of construction and maintenance.

13.3 Residential Property

We are all familiar with the basics of residential property, having lived in it for all our lives.

As we saw with commercial property, the specifications are set so that the buildings and roads will be able to cope with heavy vehicles hauling huge loads and with hordes of people arriving at shopping centres and offices to shop, work and be entertained.

The building materials used and the way in which they are used are very different when it comes to constructing homes. The cables used to supply electricity are of a lighter gauge than that used for commercial buildings. The water and waste services are also smaller and made of lighter, cheaper materials because they don't have to deal with the same stress that commercial property facilities have to handle.
For these reasons, residential property is substantially less expensive to construct and maintain.

FACT

Renting from private landlords almost doubled over the decade 2001-2011

Source: ons.gov.uk

13.4 Who Invests in What?

The residential and commercial investment markets attract different types of investor.

The commercial market is generally a long term commitment where the expense involved in constructing the buildings is amortised over a long period of time. Tenants usually lease premises for far longer than residential tenants. The other side of the coin is that there can, and often are, very long periods where commercial premises stand empty.
Selling a commercial premises can also take a long time; in some cases, years. If the property has a tenant with a long lease, the sale will be far easier. If it is standing empty, it can remain on the market for a very long time.

The residential market has a far faster turnover of tenants and the premises is far easier to sell; houses in reasonable condition stay on the market for a matter of a few months on average before they are bought by the next family wanting to set up a home.

Because of the differences between the two markets, residential property is seen as a shorter term lower risk investment than commercial property. However, the returns on commercial investments are far higher than on residential investments.
It is for this reason that commercial property attracts big investors with large amounts of capital to invest. Pension funds, insurance companies and banks are usually the biggest players in the commercial market. They tend to invest in the construction and management of large office blocks and industrial parks.

Individuals who have built their portfolios over a long period of time will be more likely to have their money in individual units in office and industrial parks where a developer has built a cluster of units and sold them off individually.

Occasionally a company looking to stop paying rent and to own their own building will buy a unit in one of these parks, but it is more usual that investors buy the premises and let them out to tenants.

It stands to reason that people who are starting out in the investment property business usually start with the residential investment market. If they are serious about investing in property, they will move on to commercial property as they gain experience, for the simple fact that the returns are greater. However, if they are looking to build a nest egg for their retirement while they stick to their chosen profession, then they will probably stay invested in the residential market.

Because the nature of the occupancy of residential and commercial property is significantly different, the lease agreements of commercial premises are far more complex than those for residential premises. This of course impacts the fees that landlords can expect to pay lawyers and management companies who draft and deal with the administrative aspects of commercial property.

In general, the commercial property investment market is populated by more experienced and sophisticated operators than the residential market. The people who invest in the commercial market usually do it on a full time basis and have a very good grasp of the complex set of attributes that make a commercial property either a good or bad prospect.

As an introduction to the property investment side of the real estate market, we will look at what it takes to invest in the residential market and what you, as an estate agent, should do to take advantage of this corner of the business.

13.5 Learning Curve

Before you set your sights on being a scout for property investors, you need to know how they think and what it is that they look for before they buy a property for their portfolio or for a client's portfolio.

The first step is to realise that property investors are patient people who are in it for the long haul. To see property through the eyes of an investor, you have to be up on everything that could possibly have an effect on the value of a property and the potential returns that the investor can expect from their investment.

You need to start reading and never stop. Financial, property and investment magazines and websites must be on your daily reading list.

Get to know a few investment advisors and find out how they view the markets and what they consider to be a good return on an investment of any sort.

Once you have set off on your learning curve and feel that you are starting to get to grips with the concepts and principles of the property investment niche, find yourself a few property investors. Get to know them and pick their brains about how they go about what they do and what they look for in a property before they invest in it.

One of the arms of residential property investment is the practice known as property flipping. This is where a speculator buys a house at a price quite heavily discounted from its market value and then sells it on as quickly as possible.

In most cases the houses that a flipper buys will be the subject of a distressed sale; the seller is expecting foreclosure, is going through a divorce, there has been a death in the family, or something of that nature.

The flipper will carry out repairs if they are needed, effect a few cosmetic touch-ups and put the property back on the market at a price more in line with what it is worth and for a good profit.

13.6 How to Find Property with Investment Potential

Once you have got yourself up to speed with the dynamics of the property investment industry and networked with a few property investors, you need to know how to find houses that they will consider.

In many instances, these houses may be out of the area that you work in as an agent. This is fairly usual. Instead of working for a percentage of the selling price of the house, agents working as property finders earn a finder's fee.
One of the most important things about looking for investment property is finding an area where there will be a good supply of tenants. It stands to reason that a house in an area where people want to live, or need to live, will be a better investment than a house in a remote area.

Your first port of call should be a local letting agency. Here you will be looking to find out what the average rental in the neighbourhood is. Armed with this, you will be able to make an initial assessment of whether any properties you find are worthwhile investments. If the average rental does not cover mortgage, rates, taxes and other expenses, then the property will not be a good investment.

Having said that, you also need to look for neighbourhoods where there are people that a landlord would be happy to rent a house to. The types of neighbourhood will dictate the type of tenant, how they will treat the house and how frequently they will move and create vacancies in the property. When you are investigating a suburb, take a look at the education structure. Are there good schools in the area and is there a university?

Being in close proximity to a university or similar institution will mean a sure supply of tenants. However, there will be a high turnover from year to year and possibly a lack of tenants for a few months at the end of each academic year.

The type of house would of course play a part in the type of university tenant it attracts. If it is a family sized house as opposed to a cottage or flat, the university staff might be a good source of tenants.

The next thing to look at is the school system. Schools, like everything else, can be good or bad quality institutions. This can impact on the value of the property in the area as parents will not want to live close to a school they are not willing to send their children to.

The proximity of a house to a school is also a factor to consider. It's a bonus if a home is within walking distance of a school with a good reputation. However, if the home is directly opposite the school, this will limit the appeal of the home as most people would rather not live too close to a school.

Municipal records are a treasure trove of information. If a suburb has high rates and taxes, it is not the end of the world. It could mean that it is a well-resourced area with a higher calibre of resident. This in turn will mean good tenants who are prepared to take out long term leases.
The crime profile of an area is a good indicator of what an area is like and if it is declining or improving. The local police station and the freesheet newspapers are good sources of crime statistics. You should also be able to source statistics on the types of crime that are more prevalent and whether they are increasing or decreasing.

The local economy is your next port of call. Research commercial development in the area and surrounding areas. Here you are looking for companies moving into or out of the area or resident companies expanding or contracting their operations. This will give you an idea on what the population movement will be like over the next few years and what effect this may have on the value of the houses in the area.

Public transport and the area's proximity to transport, commercial and recreational hubs is critical. A sign of a good neighbourhood to invest in is a blend of amenities such as parks and open areas, shops and public transport.

New development is a positive sign, but there are some developments that can signal a decline. Look for positive developments, but also look for negative things like major roadworks, development on public space or the possibility of a large building being erected near your target house.
If there is a high turnover of property and high tenancy rates, this could be a signal that the area is in decline. Look for the reason for the high turnover as it might indicate an alternative investment opportunity or be a clear sign to delete the area from your search.

Another source of high tenancy rates is seasonal letting where a town is close to the coast or some other attraction that fills up in summer.

Your last consideration must be to look at the greater area. This is as important as all the other aspects you have looked into as it could cancel the investment value of the property as easily as any other negative aspect.

Taking a macro look at the region, find out from which direction the prevailing wind comes from and if it brings any form of pollution into the area. There could quite easily be a quarry upwind of the suburb that supplies a constant stream of fine dust to the area. This may not be evident from your initial visit, but it could well cause a high tenancy rate, which is a negative.
Some areas are prone to natural disasters such as flooding and seasonal high winds. Find out what the situation is and if it poses a problem.

Once you have got all your facts together, you need to weigh them up. It could well be that some of the negative aspects are far outweighed by the positive and what would be a fatal flaw in one neighbourhood may be negligible on another.

Take a Quick Recap Test

[viralQuiz id=212]

13.7 Taking Your Prize Home

People who invest in property have strategies and plans that they use to manage and assess their portfolios against.

You will need to know what a person's goals and strategies are before you suggest properties to them.
If you have done your networking efficiently, you should be on good enough terms with your contacts to be able to speak openly with them about their portfolios. When this is the case, they will probably come to you and tell you what they are looking for.

You will need to know if the investor manages their own properties or if they have a management company doing it for them. If they do it themselves, then the location of the property is probably important to them. They are unlikely to want properties beyond a certain distance from the area they live and work in. Travel costs are high and they would factor into the overall cost of the property as an investment.

If they use a management company, they will probably be happy to look at prospects in more remote locations.

A great part of investing in property is being able to optimise an investment by making improvements to the property that enhance its value and enable an increase in rentals. When you are scouting properties for investors, it is advisable to make a note of aspects of the property that can be improved and what you think the effect of the improvement will be.

Potential investors will be looking for homes where they can effect improvements relatively easily. Their strategy should include a policy on improvements which sets out the ratio that the cost of the improvements must have on the increased value of the house.

13.8 CGT - Tax Implication for Buyers

In the UK, buyers must pay tax of 20% on capital gains after investing in property. For example, if a property is bought for £200,000 and sold later for £280,000 the profit is £80,000, which is charged tax at 20%.

However, there are various tax write-offs that can be taken advantage of, such as:

- Interest on the property mortgage
- Interest on the credit card that used to pay for part of the property
- Maintenance and repairs
- Legal or professional fees

In general, capital gains tax is paid on any property that is not a main home, which may include:

- Business premises
- Buy-to-let property (property bought specifically to be rented out)
- Inherited property
- Land

If the property is used as a business asset or occupied by a dependent relative, then capital gains tax need not be paid. In the UK, the 3% rise in stamp duty and loss of full mortgage tax relief is a significant expense. In effect, a private property purchaser pays less stamp duty than a property investor.

However, according to new tax rules, landlords can no longer claim full mortgage costs against tax; instead they will receive a 20% tax credit against interest on mortgage. Also, landlords are now required to add their monthly income to rental income and pay tax on the total amount.
Even if a property is bought as second home, it may be considered as an investment property - as another property is already owned.

Summary

People who buy property for investment purposes have well defined strategies, plans and goals. As an estate agent in either commercial or residential property, it is a very good idea to network with property investors. You will be able to provide a very useful service to them as they need to have, and often work with, property scouts.

Before you go off and attempt to offer your services to investors, make sure that you are as informed as you can possibly be. The only way to do this is to make contact with several investors. Associating with them will enable you to learn how each one thinks and plans their investment strategies and manages their portfolio.

Presentations to investors should be as detailed as presentations to ordinary buyers, with the added observations of how the property could benefit the investor's portfolio. Over the years, working with investors can prove very lucrative. You want to develop a relationship of trust where your credibility is beyond question.

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