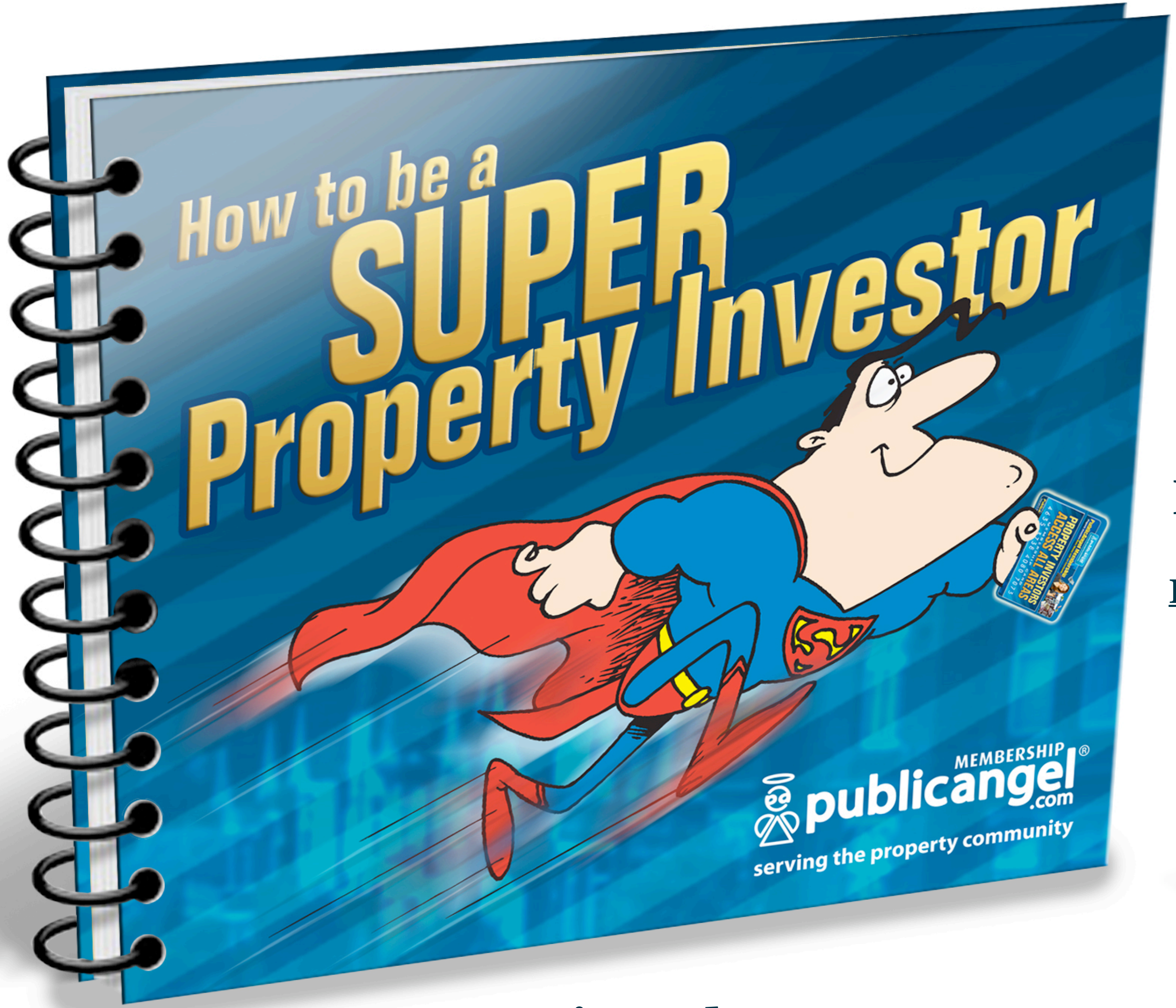

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serving the property community

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Why use property to become wealthy?

Everyone knows house prices can increase or decrease in value, however, history and experience shows that in the medium to long-term, house prices will increase an average 5-8% year on year. In real terms, a property will double in value every 7 to 12 years. It is important to understand the factors that influence the price increases.

Why do house prices increase in the long term?

Government figures show a massive shortage of good quality housing in the right locations in the UK.

a) This in the main is due to demographic and social changes such as smaller family units, more people living alone, high divorce rates and more of our senior citizens living longer without the appropriate funds.

b) With the continuing expansion of the European Union, larger numbers of immigrants and asylum seekers are being allowed into the UK, thus creating far greater need for more housing.

c) There is a definite increase in the number of people who are upgrading to larger premises and no longer wished to sell their old home, but would rather rent out their home to create a monthly income, thus realising an asset they can leave to their siblings.

Why use property to become wealthy?

d) Strict control of the green belt restricts the amount of property developments throughout the UK. The construction of new homes has been vastly reduced, pushing up prices of existing property. The government prefers to encourage the regeneration of our inner cities, unfortunately we are slowly running out of land to build on.

e) Mortgage lenders are increasing the amount of personal borrowing and extending the time to repay the loan, falling in line with the increased house prices. This situation increases the confidence in the housing market as the leading institutions are prepared to take on more risk.

Why do house prices fall in the short term?

There will always be times when even with a housing shortage, prices can fall. Here are some reasons to explain why.

a) When there is a threat of interest rate rises on the horizon, buyers can hold off buying until the interest rates have been reduced. This will reduce the number of sales and some will be forced to reduce the house price accordingly.

b) A rise in prices for utility services can influence the house prices as buyers on tight budgets will postpone purchases for more favourable times.

Why use property to become wealthy?

c) If a leading manufacturer has closed down or moved overseas to cut costs, then this has an effect on the local housing market as employees may be forced into repossession or down grade. This in turn will create an abundance of houses for sale in a specific area, over a short period of time.

d) Lack of regeneration in depressed areas of the country will force people to sell and move out. If this is not addressed by the government then there will be wave of houses being placed on the market creating an over supply.

e) In every property cycle of 7-12 years there is a short term dip in house prices brought on by several economic factors such as recession, tightening of lending, natural disasters etc.

Borrowing money to buy your assets

Unlike the stocks in the shares market, a bank will allow you to borrow large sums of money to purchase your properties. The lenders (banks) are knowingly confident that should you ever fall behind on your repayments, they can repossess the property and still make a handsome return on their investment. For this reason banks encourage the lending on properties.

Let's look at a simple investment equation.

You wish to buy a property worth a £80,000 with a buy-to-let mortgage. You approach the lender (banks) with a deposit of £12,000 which is approved. Once you've purchased your property, its value increases by an average of 8% to £86,400.

Why use property to become wealthy?

You have now made £6,400 profit from an initial investment of £12,000 pounds. That is over 50% return on your investment.

Tenant pays for your investment

The tenant provides the rental income for your investment properties, providing ample financial cover to meet the initial mortgage payment, management and maintenance each month. In real terms, you have any appreciating asset that has been purchased in the main through someone else's money, and is maintained on a monthly basis by the income from your tenant.

Summary

In this section you need to have understood the following:

- **The 5 factors that increase house prices in the long term**
- **The 5 factors that reduce house prices in the short term**
- **Why banks lend you money to buy properties**
- **How your tenants can help to pay for your investments**

Understanding the basics

Appraising the profitability of any potential property correctly is essential. You need to be able to work out if the property you wish to buy is going to leave you with a profit at the end. Over the next few pages I will explain some of the methods used to assess profit or loss on each property.

Gross Rental Yield

The following formula is used to calculate the Gross Rental Yield of a property.

$$\text{Gross Rental Yield \%} = \frac{\text{Annual Rent}}{\text{Property Value}} \times 100$$

The Gross Rental Yield is calculated by dividing the annual rent by the property value and is realised by a percentage.

Understanding the basics

For example

A property worth £90,000 which generates an annual rent of £4,500 will have a gross rental yield of 5%

$$5\% = \frac{£4{,}500}{£90{,}000} \times 100$$

The Gross Rental Yield is a good way of comparing similar properties to evaluate the most profitable option. As you can see from the example below, property A is more profitable than property B.

Property A $7.6\% = \frac{£6{,}500}{£85{,}000} \times 100$

Property B $3.7\% = \frac{£3{,}500}{£95{,}000} \times 100$

Understanding the basics

Net Rental Yield

The gross rental yield is a good way to make comparisons, however it does not allow for any running costs.

The Net Rental Yield of a property can be a better measure of a properties profitability as it takes into account the running costs.

The following formula is used to calculate the Net Rental Yield.

$$\text{Net Rental Yield \%} = \frac{\text{Annual Rent} - \text{Running Cost}}{\text{Property Value}} \times 100$$

Understanding the basics

The example below shows 2 properties with an identical Gross Rental Yield however, when you take into account the running costs, it becomes apparent that property A is more profitable than property B.

Property A $6.9\% = \dfrac{£6,500 - £600}{£85,000} \times 100$

Property B $6.3\% = \dfrac{£6,500 - £1,100}{£85,000} \times 100$

At this point we have not included the cost of borrowing from a mortgage or any applicable tax, as this is individual to each person.