Illusion No. 12

GINESTA REAL ESTATE'S KNOW-HOW BRIEFING LETTER

Nobody can tell you how good the yields on a property are.

Is that really true? To learn more about the evaluation of yields, keep reading this informational brochure.

Nowadays, investment properties (or "income properties", such as commercial real estate/multi-family residential projects) are always transacted with a statement of gross returns (yield). The gross return, however, is a highly imprecise measurement of a property's potential yield. Often hidden within a gross return is a diversity of expense items that are paid - sometimes intentionally, sometimes by mistake - by the buyer or property owner. Thus, it makes sense to conduct a comprehensive audit of a property before acquiring it. An owner should always look at the current situation with a critical eye, and implement optimization measures. These can be divided into 5 levels:

1. Expense analysis

As a first step, you should analyze the expenses of the entire property. In doing so, it is important to differentiate between expenses that would normally be offset/paid by the tenants themselves (as pass-throughs) and general operating expenses that always have to be paid by the owner.

Incidental costs that may be passed through to the tenant/lessee

Heating, hot water generation (boiler), hot water supply, cold water, waste water, superintendent salary, general electricity, TV fees, service fees for systems, equipment and elevator, elevator operating costs, garbage fees and administrative compensation for any incidental expense invoices.

Incidental costs that must always be paid by the landlord/lessor

Operating expenses like insurance premiums, repair and maintenance expenditures, any rent and lease interest owed to third parties, utility supply and disposal, administrative costs and lease income losses cannot be imposed on the lessees, and are always incurred at the owner's expense. Although these facts are not new for the home owner, it is not uncommon for new investors to make serious errors when issuing lease agreements. An expense analysis reveals the value creation potential of a property, and unveils improvement potential.

2. Income analysis

In this analysis, the actual lease rates of the investment property are compared with market lease rates. To do so, it is easiest to determine the annual unit lease rate per m^2 of net living space. Even if, for the moment, the lease rate income cannot be adjusted to a higher market level, the potential to optimize income exists, which can be exploited when there is a change of tenants.

3. Audit and budgeting of future investments

Regular planning and audit of necessary future investments (e.g., capital improvements) is within the scope of any owner's or buyer's duties. While no one can stop a property from aging, the prudent investor can optimize yields through careful renovation steps. For older properties in particular, it is advisable to set up a 5-year to 10-year investment plan, and to update these on an ongoing basis. From a tax perspective, although it is prudent to spread the investments across several years, one should not underestimate the value of comprehensive one-time renovations to income-producing properties, because in this case, from the tenant's perspective, it is more optimal to shift the costs to the lease relationship, or because certain capital improvements cannot be implemented at all if the property is fully utilized.

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4. Capitalized earnings valuation

As a next step, the prudent investor will determine the investment (asset) value of the property - to the extent this is not already established in the form of a purchase price. Various valuation benchmarks are used to assess an income-producing property. Normally, either the static income approach or the dynamic discounted cash flow analysis (DCF) is applied. Even net asset value methods should be applied for control purposes, especially in locations of a high-prestige character and very high land prices (e.g., evaluate the possibility of conversion to a multi-floor condominium).

For all methods, you have to establish the commensurate capitalization rate. It is usually rather difficult for the layperson to fully comprehend the optimal determination of the capitalization rate. But even professional a praisers must be particularly careful in the selection of a capitalization factor. The current interest rate serves the appraiser as the base interest rate for a risk-free, long term investment (e.g., federal treasury or Swiss confederation bonds). Furthermore, a risk surcharge for real estate, and a surcharge for administrative costs have to be defined, as well as for secondary costs and vacancy reserves for renovations. The experienced appraiser can determine a definitive capitalization rate on the basis of these risk factors and based on his or her long term experience. In this respect, he or she should be transparent about what informs his or her assumptions and considerations, present this capitalization rate or the derivation of the capitalization factor, and openly disclose their value components.

5. Yield optimization

Net investment return has nothing to do with net lease rates. In principle, the net investment return is derived from the net lease rate, after deducting for all costs that are not paid by the lessee/tenant. This also includes any mortgage interest costs. As a first step, an investor will determine the net return before borrowed capital, even if he or she plans to finance the property eventually with a mortgage loan. The ”net return before interest on borrowed capital“ determined in this manner is referred to as the ”return on equity.“ In this way, it is not diluted by financing costs.

Next, it is important for an investment property owner to ensure that the return on equity is higher than the interest on borrowed capital. This is the only way to achieve optimization potential. If the return on equity is replaced borrowed capital tied to steep interest rates, then the return on equity yield increases, resulting in a leverage effect. With favorable interest rates, today a net investment return before borrowed capital of approximately 4.5 % to 7 % to 8 % can be achieved under favorable financing terms.

Thorough due diligence is indispensible to any buyer or owner of a multi-family residential property, in order to ascertain optimization potential and to evaluate related implementation stages. Expenses can be optimized through cost reductions, whereas profits can be optimized by increasing returns. The leverage effect should be reviewed for its conformance to the investment strategy and yield expectations, and utilized consistently.

CHECKLIST

- How high is the effective cash flow? Which types of expenses are incurred, and what expenditures can be cut or eliminated by installment payments or lump-sum payments of secondary expenses? Have secondary costs been passed through to cover expenses, or does the owner pay for these out if his or her own pocket?
- How high are the adjusted net lease rates per unit, and per m2 per year? What would the current potential market lease rates be if the property were fully re-leased?
- Which investments apply to the owner over the next few years, and how cost-intensive are these?
- What is the personal expectation of investment returns, and how can this be increased using aleverage effect?

- Were the lease rates adjusted for cost of living and general consumer price increases?
- Were tradesmen, gardeners and other suppliers controlled and compensated at fair market prices?
- Were adequately high lease deposits required? What has the payment history been to date, and have there been any losses of rent?
- Were the unit transfers documented in professional manner? Can a tenant be held liable for damages upon move-out?

The Multi-Family Residence Check-UP

Any multi-family residential property should be inspected on a regular basis by a real estate and property management specialist. Ginesta Immobilien has developed a unique service package for this purpose, where the property is examined from a variety of perspectives. A Multi-Family Residence Check-Up is a fee service and normally includes 2-3 work sessions and a property inspection. It is primarily geared toward individuals who manage their property themselves, or who are no longer satisfied with their property management company, or who are reviewing their property for potential sale. The Multi-Family Residence Check-Up entails the following investigations:

Multi-Family Residence Check-UP:
1. Gross and net yields
2. Return on equity and leverage effects
3. Current fair market value
4. Current leases versus market lease rates
5. Operating expense and maintenance cost analysis
6. Review of required scheduled investments
7. Tax effects for real estate owner
8. Assessment of potential
9. Action plan with summary of optimization options

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Claude A. Ginesta is a federally licensed real estate fiduciary (registered with the SVIT, the Swiss Federation of Real Estate Fiduciaries) and owner and CEO of Ginesta Real Estate AG. The company was founded in 1944 and specializes in the sale of properties in the Zurich and Grisons markets. With offices in Küsnacht, Horgen and Chur, the company operates as real estate broker throughout Switzerland for properties located across the country.

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