



# Investment Analysis Report

24 Trevor Terrace  
North Shields  
Tyne & Wear  
NE30 2DE

22nd January, 2007

## **Contents**

Summary of Findings and Recommendations

Introduction

Analysis Guide

Investment Analysis

Interest Bill

Property Value and Debt

Property Cash Flows

Property versus Cash

Loan Analysis

FAQ's

## **Summary and Recommendations**

Firstly our clients want to know what will my income be and what will be the growth, in real terms, of my invested capital?

The last two lines of the Investment Analysis give the answers to these two questions.

[Please note as a means of comparison; in the last ten years the average annual return of the FTSE ALL Share Index is **8.1** per cent, for Gilts, (government bonds) it is **8.54** per cent and for the commercial property IPD All Property Index, the return is **11.3** per cent, all before tax is paid.]

Warren Buffett, generally recognised as the world's most successful investor, has achieved an average annual return on his capital over 40 years, of 21.5% through his investment company Berkshire Hathaway. His personal wealth is estimated to be \$53bn.

Secondly, our clients want to know should I buy?

When deciding whether to buy an investment property, context is important. The results of the analysis should be viewed in the light of the investment objectives of the individual client. For example a client may consider income to be a low priority and capital appreciation high, with say local proximity for ease of management. Others may have a different combination of income, equity, management and risk.

Therefore, whilst the results of our analysis are highly objective, our Recommendations are a guide and should be seen in the context of our client's investment needs.

We consider the investment performance of this prospective purchase to be such that we recommend:

**\*\*\*\* A solid buy, with good prospects.**

## **Introduction**

With the limited performance of traditional forms of investing; shares, mutual funds and pensions, many investors are turning to the property market as a means of securing their long term income.

Buying a property-to-let, is not the same as buying a property to occupy oneself. Different criteria are needed to assess, in financial terms, the rental and capital appreciation performances.

Traditionally the 'yield' has been taken as the measure of investment performance. In simple terms, this is the rent divided by the purchase price of the property, expressed as a percentage.

The Yield is of limited use, because it leaves out items such as; the amount borrowed, the cost of borrowings, buying expenses, maintenance costs, inflation, depreciation, cash flows, rates of capital appreciation etc. etc.

This report includes all of these items and many more in determining the cash flows and the internal rate of return, over a given period.

It enables the first-time, as well as the professional investor, to assess with ease, the actual and comparative financial performance, of a prospective property purchase.

## **HOW TO READ THE REPORT**

For a detailed explanation read the following alongside the table of results headed 'Investment Analysis'. Each sub-heading below; refers to a line in those results.

### **1) Investment Analysis**

#### **Renovations:**

Renovations are included as an original input and are estimated by the client.

#### **Capital Growth:**

The capital growth rates are formulated on a complex model which includes data from the Land Registry, unemployment figures, industrial output, bank rates, business activity, property sales, office rents etc. In all, over one hundred factors are used. Normally a report will be supplied with a total predicted duration of five years, but other periods can be taken.

The forecast applies to England and Wales only.

We cannot offer an absolute guarantee because the strengths and consistencies of the relationships that the forecasts rely upon vary greatly, so no individual forecast can ever be guaranteed. Also, the further into the future the period of study is taken, the less confidence is held in the accuracy of that forecast. However, we attempt to optimise the best technology and data available, to ensure that the most likely outcome is offered.

#### **Property Value:**

Calculated from the given initial market value, renovations and capital growth forecast.

#### **Loan Amount:**

Value of the outstanding loan, throughout the examined period.

#### **Equity:**

Calculated from the property value, less the loan amount.

#### **Inflation Rate:**

There are a number of measures of inflation including; the Consumer Price Index (CPI), the headline Retail Price Index (RPI), the RPIX (excludes mortgages), the RPIY (excludes mortgages and direct taxes) etc. For the purposes of this report the measure of inflation used, is the headline RPI, currently at an average rate of 2.7%.

#### **Gross Rent:**

Estimated by client and thereafter increased in line with inflation.

#### **Principal Repayment:**

This is the amount paid to reduce the loan on a conventional 'principal plus interest' basis.

**Interest Rates:**

Specified by the client from the loan details.

Where a variable rate loan has been used, the latest and the best data have been used to forecast future interest rates.

The initial rate used is the current rate at the date of this report of 4.94% and the current Bank of England Rate is 5.25%. At the time of writing this report, it is possible that the base rate may increase by 0.25% in the short term, but thereafter to fall gently, into the latter half of the time span of this report. Thus, taking an average figure of 5.49% is seen to be prudent and is a typical rate for a new buy to let mortgage at the present time.

**Loan Interest**

Calculated from the loan type, amount and term of the loan.

**Additional Repayment**

Specified by the client.

**Total Loan Payment**

Calculated from the loan principal, interest and additional payments.

**Special Expenses**

Specified by the client.

**Total Property Expenses**

From the initial yearly expenses, inflation rate and special expenses.

**Pre-Tax Cash Flow:**

The simple 'yield' does not take into account how much cash the purchaser will put into the property. The Pre-tax cash flow takes into account all of the expenses, such as maintenance, property management fees, the vacancy rate, repairs, gardening, principal repayments, mortgage application fees, appraisal fees, to name just a few.

If all of these factors are taken into account, then we have a fairly good picture, a snapshot in fact, of how this property will perform, at any one point.

The pre-tax cash flow and the pre-tax cash on cash return, (shown as a percentage in the appendix), is far more useful than the yield, in determining if a property is a good investment.

**Pre-cash cash on cash**

The initial cash investment, additional repayments, if any, and pre-tax cash flow.

**Depreciation – Buildings**

There is no depreciation allowed by the Inland Revenue on buildings.

**Depreciation – Contents**

Calculated from the contents value and contents depreciation rate.

**Total Deductions**

From the total property expenses, depreciation on contents and loan interest.

**Tax Credit**

Calculated from standard tax rates, rental income, total deductions and marginal tax rate.

**After-Tax cash flow:**

From the pre-tax cash flow and the tax credit.

**After-tax cash on cash**

Calculated from the initial cash investment, additional repayments and after-tax cash flow.

## **Client Income**

Using all of the input data, this is the estimated weekly income for the prospective purchaser.

## **Internal Rate of Return:**

The cash on cash return is far more useful than the yield in determining if a property is a sound investment. Nonetheless, it still is just a snapshot at one point in time. The Internal Rate of Return is an even better measure of investment performance. If the cash on cash return is a snapshot, then the IRR is the movie, or DVD.

The internal rate of return looks at how the cash flows and property values change with time. To do this it takes what the projected growth rentals will be, what the capital growth is expected to be, what the mortgage interest payments will be, if the principal is slowly being paid off, and what depreciation can be claimed each year.

Then the appropriate rate of inflation is used to calculate the Net Present Value of the inflows and outflows, in any one year.

Another way of thinking of the internal rate of return, is the return a bank would have to give you, such that if you gave the bank the initial cash investment in the prospective property, they would give you the annual net inflow from the property for each of the years over the period and at the end of the period, gave you back your increased equity in the property.

IRR takes the time value of money into account. Each pound of income now is worth more than a pound in say five years time and a pound of cost in five years time is less than a pound now.

The additional feature of IRR, is that it is what is called 'dimensionless', i.e. it is just a number, expressed as a percentage. This means we can compare the IRR for say, a two bedroom apartment in one location with a three bed semi in another, or a retail/commercial investment, in a third. Or, indeed with any other investment. This sophistication of analysis greatly helps decision making by reducing risk.

## **2) Who Pays the Interest Bill?**

This section shows who, effectively, makes the loan interest payments. Contributions may come from the rental income, tax credits and the investor. A negative figure in the 'you column', means that this will be income for the investor.

## **3) Property value and debt**

This section illustrates the value of the property and the property loan/mortgage, over time. It shows the build up of equity in the period.

## **4) Property cash flows**

In this section the pre-tax and after-tax cash flows are shown.

## **5) Property versus cash**

This report compares the performance of the initial cash investment in the prospective property, with an investment of the same amount of cash in the bank at a specified current rate. In both cases, the income is taxed at the appropriate rate.

## **6) Loan Analysis**

This report shows details of the loans taken out to acquire the property. Details on the loan amounts, principal payments, interest rates, loan interest and total loan payments are shown.

## FAQ's

*Q. Why include a measure of inflation?*

A. Future earnings and costs are discounted in line with a forecast inflation rate. The value of a pound today is not the same as the value of a pound in, say, five years' time. Any calculation involving amounts in the future, must reflect this change in value.

*Q. Can income tax be used?*

A. Tax – the default is at the standard rate of income tax, currently 22% (as at May, 2005). However, specific tax computations can be made, if the client wishes to supply details of their tax position.

[In Appendix A, a tax credit with a minus figure, indicates that this is the tax to be paid.]

*Q. Can buildings be depreciated for tax purposes?*

A. Depreciation of buildings in the UK is not generally allowable by HM Inland Revenue.

*Q. How about other depreciation?*

A. Depreciation of fixtures and fittings (contents) can normally be claimed.

*Q. What period can be examined in the report?*

A. In most cases the first five years of a project is given in the report and is normally sufficient to make a purchasing decision. Other projections can be made, but obviously the further into the future the primary data is forecast i.e. interest, inflation and capital growth rates, the more problematical and less accurate the data becomes.

*Q. How do you do forecasts?*

A. Mathematical relationships are sought between past and present prices and also between a price to be forecast and other information, such as interest rates. If the relationship is strong enough to justify an attempt at forecasting, mathematical models are built to use in the forecasting process. We do all the sums for you!

*Q. Can you guarantee the forecasts?*

A. No. The strengths and consistencies of the relationships that the forecasts rely upon vary greatly, so no individual forecast can ever be guaranteed. However, we attempt to optimise all forecasting technology to ensure that the most likely outcome, on the basis of the data history, is used.

*Q. What is a neighbourhood?*

A. A neighbourhood is defined as a postcode sector. A postcode sector is the full postcode, but dropping the final two letters. So for the property postcode NE29 6XY, the postcode sector or neighbourhood would be NE29 6. The forecast is for England and Wales only, at this stage.

**Property Name** Trevor Terr, 24

**Location** UK

<b>Purchase Price</b> £90,000.00	<b>Market Value</b> £105,000.00
<b>Closing Costs</b> £1,368.00	<b>Cash In</b> £24,212.00
<b>Total Cost</b> £100,143.00	<b>Loan Amount</b> £76,530.00
<b>Building Value</b> £67,500.00	<b>Loan Cost</b> £599.00
<b>Contents</b> £1,800.00	<b>Annual Rent</b> £5,557.50
<b>Expenses</b> £1,077.00	<b>Management</b> £263.98

<b>Investment analysis</b>	<b>YEAR 1</b>	<b>YEAR 2</b>	<b>YEAR 3</b>	<b>YEAR 4</b>	<b>YEAR 5</b>
Renovations	0.00	0.00	0.00	0.00	0.00
Capital growth	2.70%	7.40%	7.60%	7.90%	6.00%
Property value	107,835.00	115,814.79	124,616.71	134,461.43	142,529.12
Loan amount	76,530.00	76,530.00	76,530.00	76,530.00	76,530.00
Equity	31,305.00	39,284.79	48,086.71	57,931.43	65,999.12
Inflation rate	2.70%	2.70%	2.70%	2.70%	2.70%
Gross rent	5,557.50	5,707.55	5,861.66	6,019.92	6,182.46
Principal repayment	0.00	0.00	0.00	0.00	0.00
Interest rate	4.94%	4.94%	5.49%	5.49%	5.49%
Loan interest	3,780.58	3,780.58	4,201.50	4,201.50	4,201.50
Additional repayment	0.00	0.00	0.00	0.00	0.00
Total loan payment	3,780.58	3,780.58	4,201.50	4,201.50	4,201.50
Special expenses	0.00	0.00	0.00	0.00	0.00
Total property expenses	1,340.98	1,377.19	1,414.37	1,452.56	1,491.78
Pre-tax cash flow	435.94	549.78	245.79	365.86	489.18
Pre-tax cash on cash	1.80%	2.27%	1.02%	1.51%	2.02%
Depreciation-Building	0.00	0.00	0.00	0.00	0.00
Depreciation-Contents	180.00	162.00	145.80	131.22	118.09
Total deductions	5,900.56	5,319.77	5,761.67	5,785.28	5,811.37
Tax credit	0.00	0.00	0.00	0.00	0.00
After-tax cash flow	435.94	549.78	245.79	365.86	489.18
After-tax cash on cash	1.80%	2.27%	1.02%	1.51%	2.02%
Your income per week	8.38	10.57	4.73	7.04	9.41
Internal Rate of Return	31.67%	29.70%	27.51%	25.98%	23.72%

**Notes:** The loan costs are included in the deductions for the first year.

Depreciation rates : Building = %

**Property Name** Trevor Terr, 24

**Location** UK

**Purchase Price** £90,000.00

**Closing Costs** £1,368.00

**Total Cost** £100,143.00

**Building Value** £67,500.00

**Contents** £1,800.00

**Expenses** £1,077.00

**Market Value** £105,000.00

**Cash In** £24,212.00

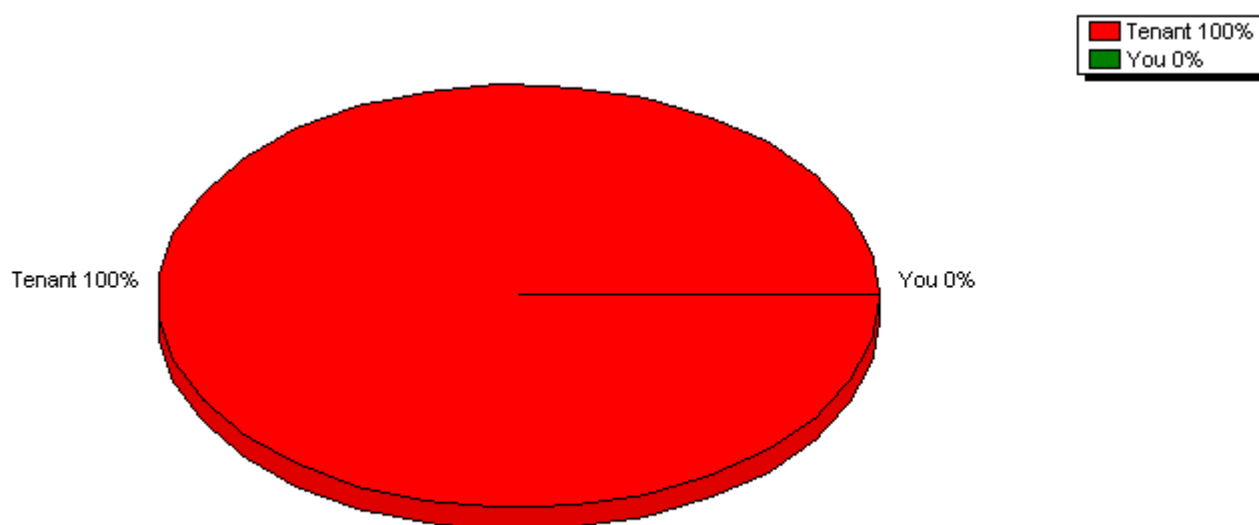
**Loan Amount** £76,530.00

**Loan Cost** £599.00

**Annual Rent** £5,557.50

**Management** £263.98

**Who pays the interest bill?**



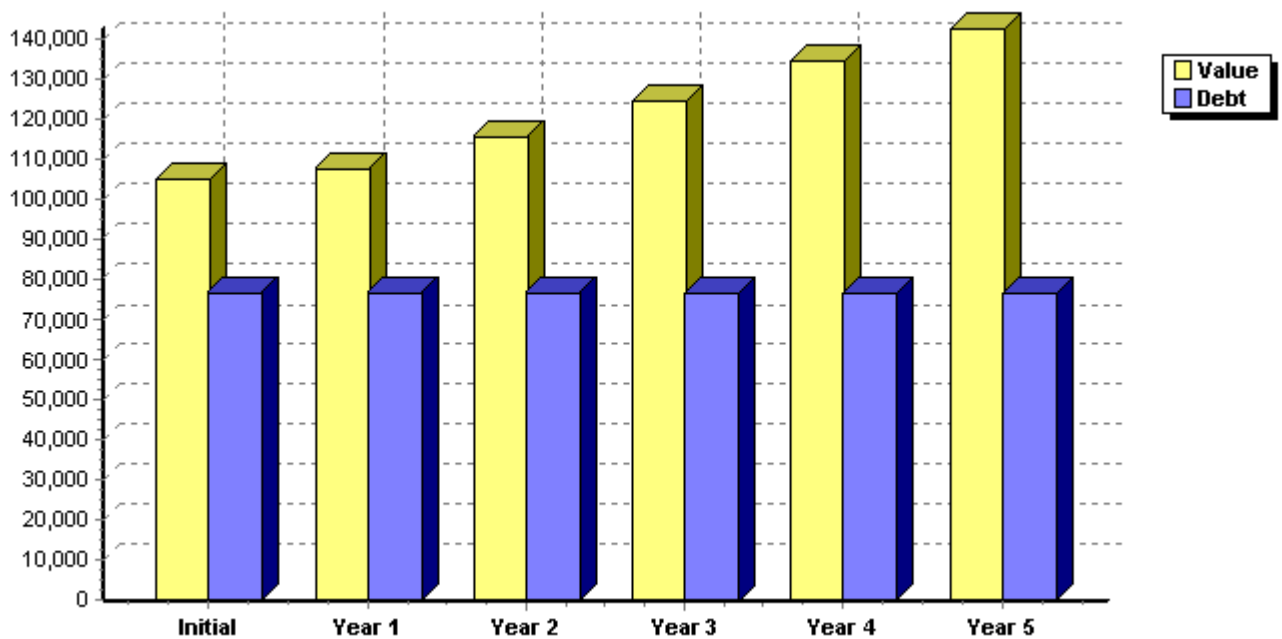
	<b>Interest bill</b>	<b>Rental income</b>	<b>Rental expenses</b>	<b>Net rent (Tenant)</b>	<b>Tax credit (Taxman)</b>	<b>Remainder (You)</b>
<b>Year 1</b>	3,780.58	5,557.50	1,340.98	4,216.52	0.00	-435.94
<b>Year 2</b>	3,780.58	5,707.55	1,377.19	4,330.36	0.00	-549.78
<b>Year 3</b>	4,201.50	5,861.66	1,414.37	4,447.29	0.00	-245.79
<b>Year 4</b>	4,201.50	6,019.92	1,452.56	4,567.36	0.00	-365.86
<b>Year 5</b>	4,201.50	6,182.46	1,491.78	4,690.68	0.00	-489.18

Property Name Trevor Terr, 24

Location UK

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### Property value and debt



	Growth rate	Property value	Amount owing	Equity
Initial		105,000.00	76,530.00	28,470.00
Year 1	2.70%	107,835.00	76,530.00	31,305.00
Year 2	7.40%	115,814.79	76,530.00	39,284.79
Year 3	7.60%	124,616.71	76,530.00	48,086.71
Year 4	7.90%	134,461.43	76,530.00	57,931.43
Year 5	6.00%	142,529.12	76,530.00	65,999.12

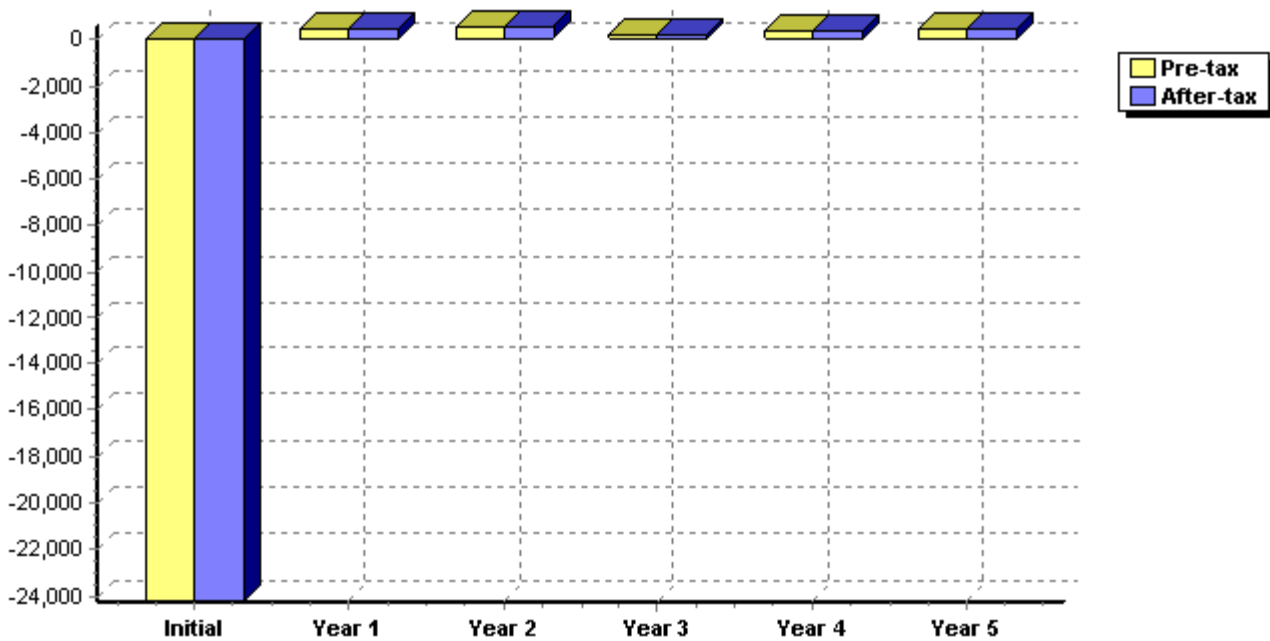
Property Name Trevor Terr, 24

Location UK

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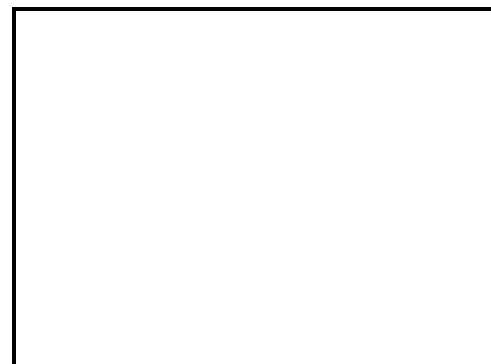
### Property cash flow



	Rental income	Loan payments	Rental expenses	Pre-tax cash flow	Tax credit	After-tax cash flow
<b>Initial</b>				-24,212.00		-24,212.00
<b>Year 1</b>	5,557.50	3,780.58	1,340.98	435.94	0.00	435.94
<b>Year 2</b>	5,707.55	3,780.58	1,377.19	549.78	0.00	549.78
<b>Year 3</b>	5,861.66	4,201.50	1,414.37	245.79	0.00	245.79
<b>Year 4</b>	6,019.92	4,201.50	1,452.56	365.86	0.00	365.86
<b>Year 5</b>	6,182.46	4,201.50	1,491.78	489.18	0.00	489.18

**Property Name** Trevor Terr, 24

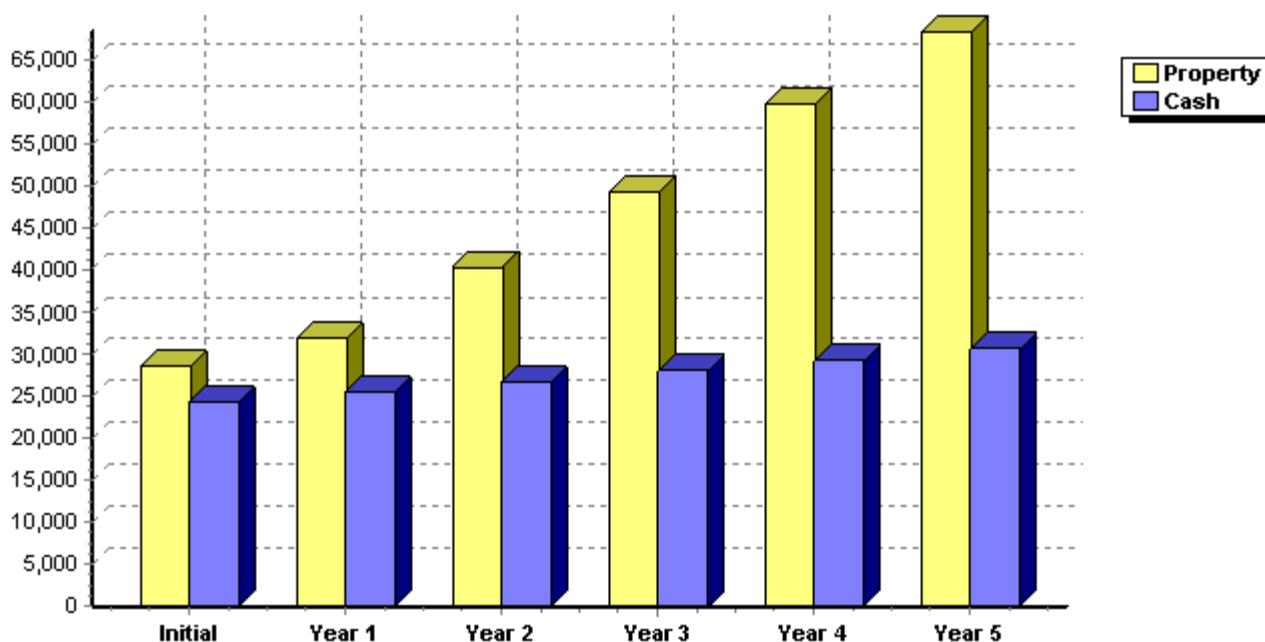
**Location** UK



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### Property versus cash

Bank interest rate is 5%



	After-tax cash flow	Cash invested	Total cash + interest	Property income	Income + interest	Property equity	Equity + income
<b>Initial</b>	-24,212.00	24,212.00	24,212.00			28,470.00	28,470.00
<b>Year 1</b>	435.94	0.00	25,394.34	435.94	446.84	31,305.00	31,751.84
<b>Year 2</b>	549.78	0.00	26,629.89	549.78	1,032.70	39,284.79	40,317.49
<b>Year 3</b>	245.79	0.00	27,921.03	245.79	1,336.27	48,086.71	49,422.98
<b>Year 4</b>	365.86	0.00	29,270.27	365.86	1,778.10	57,931.43	59,709.53
<b>Year 5</b>	489.18	0.00	30,680.24	489.18	2,368.41	65,999.12	68,367.53

**Notes:** The above comparison assumes that investments made in the property are invested at the interest rate shown and the interest is taxed. Similarly, any income from the property is invested at the specified interest rate and the interest earned is also taxed.

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**Location** UK

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<b>Loan analysis</b>	<b>YEAR 1</b>	<b>YEAR 2</b>	<b>YEAR 3</b>	<b>YEAR 4</b>	<b>YEAR 5</b>
Loan amount 1	76,530.00	76,530.00	76,530.00	76,530.00	76,530.00
Loan amount 2	0.00	0.00	0.00	0.00	0.00
Loan amount 3	0.00	0.00	0.00	0.00	0.00
Loan amount 4	0.00	0.00	0.00	0.00	0.00
Principal repayment 1	0.00	0.00	0.00	0.00	0.00
Principal repayment 2	0.00	0.00	0.00	0.00	0.00
Principal repayment 3	0.00	0.00	0.00	0.00	0.00
Principal repayment 4	0.00	0.00	0.00	0.00	0.00
Interest rate 1	4.94%	4.94%	5.49%	5.49%	5.49%
Interest rate 2	0.00%	0.00%	0.00%	0.00%	0.00%
Interest rate 3	0.00%	0.00%	0.00%	0.00%	0.00%
Interest rate 4	0.00%	0.00%	0.00%	0.00%	0.00%
Loan interest 1	3,780.58	3,780.58	4,201.50	4,201.50	4,201.50
Loan interest 2	0.00	0.00	0.00	0.00	0.00
Loan interest 3	0.00	0.00	0.00	0.00	0.00
Loan interest 4	0.00	0.00	0.00	0.00	0.00
Additional repayment 1	0.00	0.00	0.00	0.00	0.00
Additional repayment 2	0.00	0.00	0.00	0.00	0.00
Additional repayment 3	0.00	0.00	0.00	0.00	0.00
Additional repayment 4	0.00	0.00	0.00	0.00	0.00
Total loan payment 1	3,780.58	3,780.58	4,201.50	4,201.50	4,201.50
Total loan payment 2	0.00	0.00	0.00	0.00	0.00
Total loan payment 3	0.00	0.00	0.00	0.00	0.00
Total loan payment 4	0.00	0.00	0.00	0.00	0.00

**Notes:** The loan costs are included in the deductions for the first year.

Depreciation rates : Building = %