Location, yields and Reverse Financial Engineering

Newsletter dated:

18 April 2012

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Part 2 of 2 – Second part of our January 2012's newsletter

In the UK professional residential investments are a long way off what we would find in continental Europe (France, Germany and Spain especially) where it is mainstream and made widely available even to retail investors. Consequently, within the UK affordable housing has long been considered even more alien to the "normal" residential property investor, and kept at bay as if it was impossible or unsuitable.

Our position is that the current environment of low growth and budget cutbacks provides an opportunity for investment managers to achieve growth and create value whilst reducing risk and exposition to market trends. Comforting our point of view, recent articles[1] and research reports[2] are clearly depicting a situation in which many European Pension Funds believe it is their fiduciary duty to act on ESG issues. Pension Funds recognise they have largely fallen behind but are willing to catch up provided some implementation issues are being addressed. And one such "implementation issue" is the question whether an ESG investment can outperform its key benchmark or at least won't underperform it.

So, does investing in affordable housing mean losing out on returns compared to more traditional investments? Well, let's explain three key aspects of our proposed investment strategy (location and greatest yields achievable coupled with reverse financial engineering) and figure things out on our own.

Step 1: Location

Apparently nothing new here, but in our case prime location means investing where there is overwhelming demand for affordable housing AND the cheapest property or land deals. Of course Greater London is mostly out of the picture, but Great Britain is a lot more than London in our field of interest.

So we might consider investing in properties ranging from a studio to a 4-bed flat, stand-alone properties or whole buildings offering multiple units. We know the local market but more crucially we know the Local Housing Allowance (LHA). Then, we know exactly how much rent we can secure at minimum risk.

Let's say the LHA for a two-bed flat in Manchester is £120/week, or £6,240/year. We can now proceed to Step 2: determining our yield.

Step 2: Greatest yield achievable

Our point is going for immediate high yields instead of potential future gains, focusing on long-term objective and redesigning the bonus structure to properly incentivise the management team and avoid any potential disconnect of interest between fund owners and property investment managers.
We want the return now, not later, and we set minimum yields to be achieved from the beginning. Then and only then, we go hunt for adequate property deals.

Following Step 1, our objective is a two-bed flat in Manchester paying £6,240 LHA per year. If we are looking for 10% yield, then the property should be priced at £62,400.

It might be more according to the targeted tenants as the full amount of LHA is for people on benefits; more affluent tenants might be paid less LHA but make more money globally with their job and pay more rent. LHA payments offer a total guaranty of payment, thus greatly reducing risk.

We now know we are globally looking for two-bed flats in Manchester priced at no more than £62,400 and the lesser we pay for this category of flat, the bigger the yield.

Step 3: Reverse financial engineering

The last step is pretty straightforward. We know where to invest, what to be looking for and we know how much money we can spend; let's go find properties fitting the financial model we have developed.

The only thing left is fine-tuning the financial package. We have decided to cap leveraging at around 50% of total investment. According to the interest rate to pay out, the amount of money borrowed, and knowing how much rent will be paid in, we incorporate some costs (overheads) and determine a thorough maintenance planning.

So we know the income, we know the mortgage payment, and we play with how long the mortgage is going to be with a maximum of 10 years, or how much we want to pay out.

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To cut a long story short, we could have for a **£62,400 investment**:

- Deposit: £30,400
- Mortgage: £32,000
- Interest rate paid out: 5%
- Mortgage payment: £450 / month
- Rental income: £520 / month
- Mortgage length: 84 months
- Cash flow available: (520-450)= £70 / month

The investment is secured as much can be, offering flexibility and great yields. The investors are happy, the tenants are happy. Let's go for it.

Olivier R i b e r t
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1 "Many pensions failing to act on SRI", FT 03/10/2011

2 "Investor Perspectives on Social Enterprise Financing", *ClearlySo* July 2011 – "Corporate Pension Funds and Sustainable Investment study 2011", *Eurosif*