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Featured Articles

A property in hand is better than two in the dream…

Key to Total Financial Planning…

- ***Financial Needs Analysis***
- ***Cash Flow Statement***
- ***Balance Sheet***

Real Estate Investment: Risks, Price and Returns

Overnight queues, balloting, blank cheques... Singapore is probably the only place on earth where the property market is still so vibrant during this economy downturn. The reasons for eager buyers to snap up home deals range from low interest rates, lower prices (than 2007 boom period), 'fear of missing the boat' to cash-rich buyers and optimism that the economy will bounce back soon.

Before you jump into the bandwagon, it is important for you to understand the risks involved in real estate investment, to determine your home affordability and the reasonable price to pay for a unit, the potential returns and how to protect this valuable investment.

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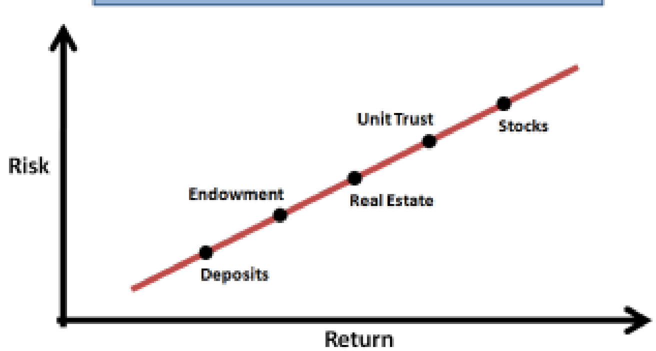
Considerations and Risks

The chart below shows the different types of investment products according to their risk-return profile. Real estate appears to be balanced between the return and risk. However, there are a few obstacles to this investment vehicle.

Ranking of Risk-Return of Investment Products



Provided you know your finance and is able to determine the reasonable value and potential return of the property.

- Real estate requires large capital investment outlay compared to investment in funds and stocks. Usually there is a need to get loan from banks with the purchased property being pledged as collateral.
- It will incur high transaction cost such as stamp duties (about 3% of sale price) and legal fees of at least $2000.
- The properties require more personal effort and time to ensure they are well run and maintained. This is especially important if the properties are to be rented out. Regular maintenance is necessary to maintain the value of property.
- There are many legal and regulatory complexities involved in real estate investments. The major regulations in Singapore are Land Acquisition Act, Planning Act, Estate Duty Act, Property Tax Act, Stamp Duty Act etc.

Besides the above considerations, real estate investment is also subjected to the following 3 risks:

- ***Liquidity Risk:*** Properties are considered illiquid investment compared to funds and stocks. The property investment process generally involves looking for a buyer, negotiating for a mutually agreeable price of property, looking for financing, and legal documentation which will take about 3 months and also renovation of the property. The whole process of completing a property transaction could take at least 5-6 months.
- ***Financial Risk:*** The performance of property investment is very much tied to the general economic performance of the country. In times of boom, property prices generally soar, resulting in large gains for property investments. However, when adverse economic conditions prevail, the potential losses could easily wipe out the substantial profits made during boom years. Since property investment are highly leveraged, the level of interest rates and the direction which the interest rate would have great impact on the cost of loans. So when the interest costs are high and the property is not producing enough rental yields to cover the cost of loans, the investor will be disadvantaged at both ends.
- ***Physical Risk:*** Of all the investments, only Real Estate Investment is subjected to the physical property being destroyed by fire, flood or any other natural disasters. Although the physical risk can be insured, the prices of properties could still be affected.

Key in Considering REI…

- ***Requires large capital investment outlay***
- ***High transaction cost***
- ***Need effort and time***
- ***Many legal and regulations***

Key to Risk Management in REI…

- ***Low liquidity***
- ***Dependent on global and local financial and economic situation***
- ***Physical damages***

If you are undaunted by the risks involved, and decide to go ahead with your real estate investment, read on to find out learn about a few measurements used to estimate the price of property and the return of your investment.

Home Affordability and Price of Property

There is no regulated exchange where properties are traded. The buying and selling of properties generally take place directly between buyers and sellers through advertisements or by word of mouth. The transacted price depends largely on negotiation and the recent transacted price for properties in the same locality.
Before committing towards your property purchase, you should

- work out your Monthly Cash Flow Statement and Personal/Family Balance Sheet (see April 2009 issue of AFP.net newsletter);
- find out the limits on the use of your CPF for property purchases and probably use the "Housing Affordability Calculator" from CPF's website at www.cpf.gov.sg to estimate your housing loan based on your income and ability to service the loan;
- discuss with a banker to determine the maximum loan amount that you can obtain, the interest rate and period of repayment for the loan.

Afford what you can. Don't let your dream home becomes your nightmare!

Housing Affordability

As a guide, your monthly mortgage payment should be between 20% to 30% of a household's total monthly income. The table below shows the rough repayment guide per $100,000 loan based on a monthly-rest calculation. It will help you to determine your maximum loan amount and psf home affordability.

Interest	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	30 yrs	35 yrs
1.50%	1 731	898	621	483	400	345	306
1.75%	1 742	909	632	494	412	357	319
2.00%	1 753	920	644	506	424	370	331
2.25%	1 764	931	655	518	436	382	344
2.50%	1 775	943	667	530	449	395	358
2.75%	1 786	954	679	542	461	408	371
3.00%	1 797	966	691	555	474	422	385

Supposedly, if your household's total monthly income is $12 000, and you have to take a housing loan amount to 80% of the property price for 25 years at an interest rate of 1.75%*, then price-per-square-feet (psf) of the property can be worked out as follows:

Items	Working	Amount
Monthly Home Mortgage	= 25% of household income	$3,000
Maximum Loan Amount	= (Monthly Home Mortgage/Monthly Repayment) * 100 000	= ($3000/412) * 100 000 = $728,155
Maximum Price of the Property	= Max. Loan Amt * 100/80	= $728,155 * 100/80 = $910,194
psf of the Property	= Price of Property/Floor Area	$958 to $728 for 950sqft to 1250sqft unit

* Bear in mind that interest rate is likely to increase when the economy recovers. If it increase to 2.75% a year later, your monthly loan will increase to $3830 (following the above calculation). This will be more than 30% of the monthly income if there is no corresponding increase in the latter.

Key to Housing Affordability…

- ***Monthly mortgage < 30% income***
- ***Low interest rate***
- ***Buy only what you can afford***

Valuation of Property

To roughly gauge the amount to pay for the value for a property, you can first work out the average Gross Income Multiplier (GIM) based on the price of property and the gross rental income that are being transacted in the same locality.

average GIM = Price of Property / Gross Rental Income

The price of property and the gross rental income can be obtained from the URA website at http://www.ura.gov.sg > Property Market > Real Estate Information > Private Residential Property Transactions with Caveats Lodged and Rentals of Private Residential Developments section.

For example, if two properties in the same project sold at $900,000 and $700,000 can fetch a monthly rental income of $4000 and $3,200 respectively, then the valuation of the property will be:

Key to Valuation of Property and Returns of Investment…

- ***Determine the ave GIM and Rental Income***
- ***Factors in all operating expenses***
- ***Actual return (ROE) may be less than Rental Yield***

	Property 1	Property 2
GIM	= $900,000/$4,000 = 225	= $700,000/$3,200 = 218.75
Average GIM	**(225 + 218.75) / 2** **= 221.875**	

The estimate of value of your new property can be computed as

Value of property = average GIM * Rental Income

Therefore, if the unit that you are getting can fetch a rental of $3,600, the price will be

221.875 * $3,600 = $798,750

which is within your $910 000 budget.

Returns of Real Estate Investment

Rental Yield

The rental yield of a real estate investment is the ratio of the net operating income to the total investment.

Rental Yield = Net Operating Income / Total Investment * 100%

Net Operating Income is defined to be the Rental Income minus the related expenses such as maintenance cost, repair cost etc. If you pay $800,000 for a condominium which can fetch a monthly rental of $3600; $300 for the monthly maintenance fee and average of $100 repair cost for the unit. The Net Operating Income per month will be $3,600- $300 - $100 = $3,200.

The Rental Yield will then be

Rental Yield = $3,200*12 / $800,000 = 4.80%

Return on Equity (ROE)

ROE take into consideration the use of borrowing or leverage in the real estate investment. This is important because most property investments are financed with debt. Therefore, the after-debt measurement of return is more reflective to the investors.

ROE = (Net Operating Income less Loan Repayment / Equity) *100%

Equity is defined to be the purchase prices of property minus the loan amount. If you have applied for a 80% bank loan, you would have to pay cash/CPF savings of $800,000*0.2 = $160 000. Hence, the equity is $160,000. Your monthly loan repayment for a 25-year loan at 1.75% is $2,640 (work out from the repayment table).

ROE = (($3,200 - $2,640) * 12 / $160,000) * 100% = 4.20%

Protecting your Investment

After the approval of bank loan of your property, you should also seek to protect your investment. Ensure that the protection value from all owners adds up to 100% of your loan amount.

Most insurance companies offer Mortgage Protection Plan (MPP) that is similar to Decreasing Term Insurance. That is, the protection value starts at the insured amount but will decrease steadily throughout the loan period. It differs from the normal Decreasing Term Insurance in that the premium term is normally less than the loan period.

For example, for a 20-year MPP with NTUC Income, the premium is only payable for 15 years. Hence, the total premium payable is less for MPP.

Even if you have sold off your property after some years, it is good to keep your MPP in-force for the added protection against Death and Total Permanent Disability.

Conclusion

To benefit from real estate investment, it is important to know your finance and able to determine the reasonable value and potential return of the property so that you do not stretch beyond your means.

If the direct real estate purchase seems too much risk and high capital to take, you could indirectly own real estate though REIT, Real Estate Investment Trust. REIT is almost similar to unit trust that focus on different type of properties such as residential, commercial and industrial, in different locations or countries. Besides, REITs offer you the diversified portfolio of real estate investment. You do not need the expertise, time and effort in managing a portfolio of real estate investment.

Do not stretch beyond your means.

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