

# Farrell's view... best of the blog

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In this regular feature, Dominic gives his forthright opinions on the news and issues that have been raised on the [bewarethesharks.com](http://bewarethesharks.com) blogs

“An experienced investor has a positive cashflow and can take a solid ten-year view of an investment opportunity and the risks associated with it”

## 1. Cashflow and the Novice Investor

One of the worst mistakes an investor can make is to ignore cashflow. Cashflow is like the blood that runs through our veins. Without it you are dead (and buried). Property investing should be treated like any other business, and to remain in any business, cashflow is paramount.

Let's look at two investors:  
**Investor A** is a novice and he buys three properties with negative cashflow. These are the first properties in his portfolio. He has been advised that capital growth is the aim and that you just 'subsidise' the cashflow in the short to medium term:

The negative cashflow is:  
Property 1 per annum = (3,000)  
Property 2 per annum = (2,000)  
Property 3 per annum = (4,000)  
One year's subsidy is £9,000 – that is, assuming that you have tenants from the beginning! Most of us who invest are aware that this platinum scenario of fully

tenanted properties on completion, paying a good rent, does not always materialise.

So, let's now assume that only two of those properties have tenants from the start and that the rents they pay are less than the predictions made in the sales brochures on which you have based your cashflow projections.

As these properties complete, a glut of supply hits the market as other developments spring up at the same time due to investor and developer appetite. Rents then fall (which explains why many projections of rent in Eastern Europe are generally not met in reality). Admittedly, over time, they will recover in line with economic activity, but this does not help the novice investor.

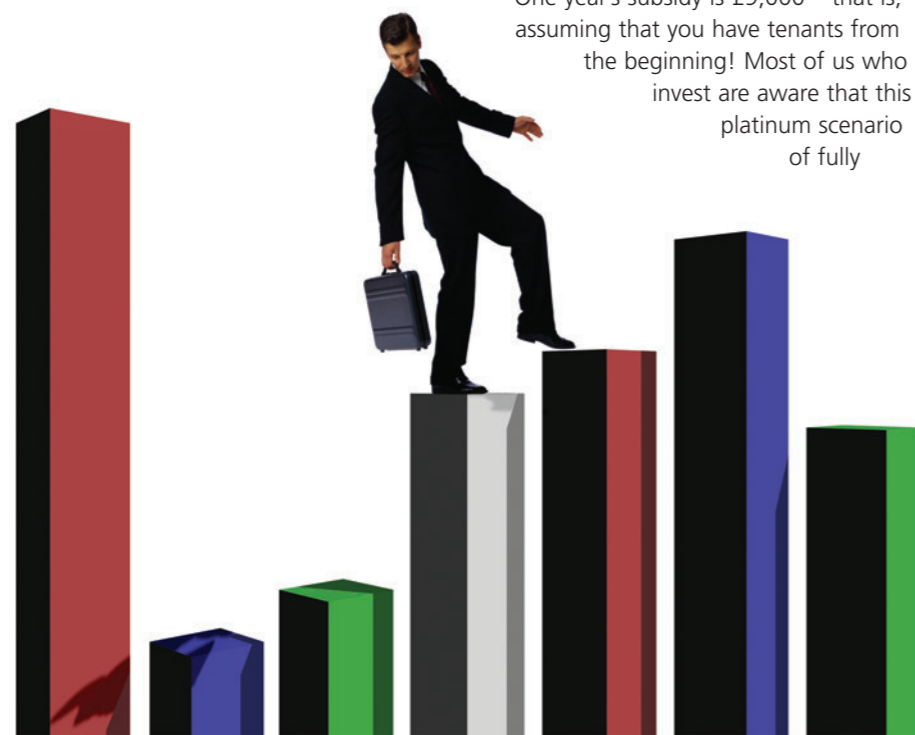
He would have to have a lot of cash to continue subsidising his portfolio over this length of time.

Let's assume that the third property doesn't rent for six months or more, further increasing our investor's costs. And then he loses his job! What then?

Well, he can sell – or can he? That depends on the re-sale potential in the market in which you are investing. Looking at the Romanian market, I was kindly sent an investment appraisal by a subscriber for properties in Bucharest. I commend the company selling these properties for its honesty in assessing the re-sale potential of the units. I paraphrase here:

“We predict that the rental market will have increased, as a growing number of people will not be able to afford to buy and will be forced to either rent, or rent for longer, before buying.”

This means that 'sell on completion' strategies in this market are more difficult and holding and renting is a more logical strategy, albeit initially in a very soft rental market.



Cashflow can determine the success or failure of an investor

So how does Investor A exit this investment when the yields will be too small for the investor market and the price too high, according to our experts, for him to sell? And, at the same time, more and more units are being brought to the market with developer incentives. Whether he can sell or not, property is not a liquid asset and as such will not be of any help in the short term.

This is a classic case of liquidity and financial risk, as he must continue to make the payments on the properties or risk foreclosure.

The increase in repossessions in the UK at present is due to higher interest rates and falling positive cashflows, whether you are a homeowner or an investor. Indeed, many novice buy-to-let investors in apartments in some of our UK cities have seen falling rents and falling prices with rising interest rates and oversupply. One company I know of actually sells these properties and bases the sales pitch on "treat it like your pension which you pay money into each

but having a completely different and opposite risk profile. Investor A has a high-risk strategy whilst Investor B, in my view, carries a low to low-medium risk.

Investing in property is not a game; it needs to be treated like any other business. When you invest in property, particularly overseas, risk has to be at the top of your list of considerations.

Two quotes from the great man himself, Warren Buffett:

“Only buy something that you'd be perfectly happy to hold if the market shut down for ten years.”

“The first rule is not to lose. The second rule is not to forget the first rule.”

If you are a novice investor, I would avoid negative cashflow investing and cut your teeth in more traditional markets where there are good solid returns in the form of income and capital growth. Build equity and income and then think about higher-risk cashflow-negative emerging markets. Avoid crazy investment logic.

## “Live life on the upward curve. This approach is adopted by many successful people at the top of their game”

month and you will see the return in years to come!” Well, if you don't have the cash to pay out and the time to wait for capital growth, you will be in trouble (not forgetting opportunity cost). As a result, Investor A is a prime candidate for a forced sale as he has no other portfolio income to help him out.

**Investor B**, on the other hand, is an experienced investor who fully understands the concept of negative cashflow investing. His current portfolio has a positive cashflow per annum of £50,000 / £75,000 / £100,000 and the subsidy of £9,000 for these new investments can be met from his existing portfolio, regardless of any change in circumstances. He will not become a forced seller and can take a solid ten-year view of this investment opportunity and the risks associated with it.

### Risk and Return

In the scenario above we have two investors making the same investment

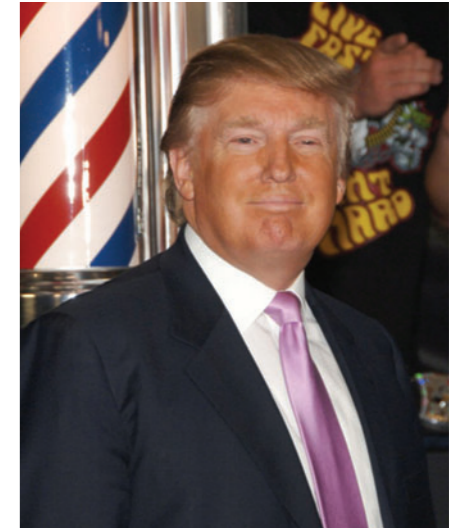
Experienced investors can make their own minds up and have the resources to reduce the risk significantly and prosper from the long-term gains offered in the less traditional markets.

## 2. Live Life on the Upward Curve

I would like to reflect on something I heard Johnny Wilkinson, the English Rugby Football Union star, say the other day. Asked by a radio presenter whether he had given up on representing England again due to injury, he categorically said no and proceeded to explain that he lived life on an upward curve.

### What is this upward curve?

The upward curve approach is adopted by many successful people. Sports people, artists, musicians, writers, entrepreneurs, property investors and developers at the top of their game strive to produce better results day in, day out. Not content with maintaining



Donald Trump  
What drives the mega-rich to keep on 'working'?

the status quo, those on the upward curve will power ahead with drive, ambition and enthusiasm to achieve the very best they can.

As many of you will know, none of this has anything to do with money! It is a state of mind. In my view, Mother Teresa of Calcutta was extremely successful in achieving her individual goals. She lived life on the upward curve and had an extraordinary determination and will to succeed, which even humbled Prime Ministers and Presidents.

So let's forget about money. Aim to be on the upward curve. If you have set yourself a goal of not working for anyone else in, say, five years' time, then get on with formulating a plan to achieve it. A consequence or by-product will clearly be money, as without it you will have to continue in employment.

Those on the upward curve enjoy what they do. It is not work, but a personal ambition to push boundaries and achieve difficult goals. Why do people climb mountains or swim the Channel? Why do explorers cross the Arctic? Why do Richard Branson, Donald Trump and Warren Buffett still 'work'?

Look back on your achievements of the past 12 months and whether you are any further forward in attaining your goals. If there is little difference between now and then, you will need to adapt or in some cases formulate a new strategy for the next 12 months.

Live life on the upward curve. ▶

### 3. Checklist for Understanding Investment Appraisals (sales brochures with numbers!)

Most property investment companies produce Investment Appraisals (IAs), which set out the various elements associated with the decision making process of investing in a particular property. An IA provides detail on the country, economy, locality, development, finance, risks and also makes a projection on income and capital growth over, say, a five-year period.

You must remember that in many cases these IAs are sales brochures with numbers. Companies producing them want to sell you something. There is absolutely nothing wrong with that, and as long as the IA is honest and accurate and you conduct your own due diligence then everything will be fine and you will make a balanced decision.

Here is a quick checklist to assist you with 'appraising the appraisal':

- Is there too much hyperbole in the text?
- Is the text opinion or backed by referenced sources?
- When claiming to have exclusive access to a development, is this true?
- Are claims of 'discounts' true?
- Is the guaranteed rental agreement real or built into the price?
- Are loan-to-value figures lowered to make the properties cashflow positive?
- Is the mortgage interest rate used in the appraisal accurate or wishful thinking?
- Is the exchange rate used valid today?
- Is the specification set out in the appraisal the same as that set out in the contract?
- Does the appraisal overpromise?
- Can the company deliver on levels of customer service?
- What are the true costs of buying the property – finder's fees, legals, mortgages etc?
- Do projected Returns on Investment belong in "Fantasyland?"



Investors need to weigh up the facts before making a decision

### “The most important aspect of buying property overseas is the contract”

The most important aspect of buying property overseas is the contract. This is the area where most people have problems. I am aware of developers in some parts of Eastern Europe withdrawing unilaterally from a contract because they know that they can sell the properties again for a higher price.

This does not help the investor who has incurred costs and also has lost out on other opportunities in the meantime. It is imperative that the contract is read and amended by an independent lawyer before signing and penalties introduced that would make it uncomfortable for the developer to conduct such unethical practices.

#### Return on Investment

I have argued for some time that a lot of figures produced by some property sales companies are truly unbelievable.

One such figure I saw recently was a company advertising that a particular development had a 300% Return on Investment, which would be remarkable given the very high entry costs of properties in the region. Well, on closer examination, I found that the Return on Investment figure didn't include costs!

Yes, truly unbelievable.