

# INTERNATIONAL INCOME PROPERTY INVESTMENT YIELDS AND THEIR MEASUREMENT

by Mary Alice Hines

Many income property investors buy, sell and lease property on an international scale. Their counselors, of course, must give advice on the same scale. They often come from real estate counseling, valuation, brokerage, accounting, management consulting and tax consulting firms.

The international investors tend to represent large sums of capital. Their own countries do not offer enough high-

yielding properties for their acquisition, or they prefer to diversify their portfolios to reduce overall portfolio risk; in some cases, the investors are seeking to avoid what they judge to be too much political and governmental risk at home. Capital preservation calls for investment outside the country of domicile. In addition, the income properties of the country of domicile may not exhibit enough domestic business and industrial growth to offer sufficient capital gains possibilities in the near future.

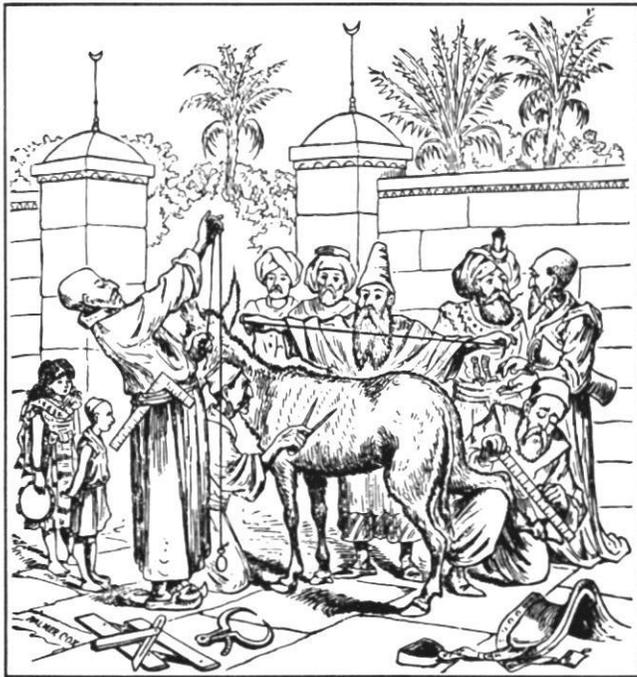
## Recent International Income Property Investment Trends

The worldwide recession from 1969 through 1982 brought with it a large investor sell-off of portfolio holdings, declining property values from relatively stringent mortgage terms, investor acquisition of "bargain" properties, investment in real estate company stock across national borders, extensive rehabilitation of existing structures, and reduced income property development. Some examples follow.

The largest British life insurance company and one of the largest U.S. life insurance companies have been selling off many of their income properties for various reasons. The sell-offs have given liquidity to the life insurance companies so that they could pursue alternative investments in the rapidly rising stock markets in the international capitals.

The sell-offs have also resulted in pension fund liquidity since these large life insurance companies have actively managed large sums for various pension funds in recent years. Due to the persistence of a worldwide recession, some of these pension funds have asked for the return of their capital. Also, with the encouragement of early retirements to counteract high operating costs during sales and profit slumps, pension funds have faced more cash disbursement demands.

In the U.S., the values of income properties have declined, generally with shorter term and higher cost income property financing. The equity participation



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requirements and the joint venture agreements stipulated by some lenders have created a higher cost of funds. With higher debt and equity costs, net cash flows have declined; decreased property values have resulted in many cases.

At the same time in the U.S., tax shelter opportunities have increased with the passage of the 15-year Accelerated Capital Recovery System for real estate. The rehabilitation tax credits have also benefited real estate investors with significant income tax problems.

International real estate investors have observed declines in income property values due to the recession and have sought bargains in the marketplace. Where they expect measurable income property value growth in recovery years, they look for current prices which will accentuate their future long-term capital gains. Small, medium, and large investors have thought along these same lines in every recession and depression that the world has ever known. Thus, this extended recession has produced the same familiar investment climate.

The decline in housing construction during the recession has brought about speculation in apartment buildings where high occupancy rates may result in rising rents. The office building glut in many large cities has provided some bargain prices for those investors who hold ample capital. Shopping center storeroom space, often vacated by retailers due to bankruptcy or reduced sales, has been purchased or leased for speculative purposes by investors. They have forecasted higher shopping center occupancy and higher rents in good centers with the return of highly profitable retailing conditions during the recovery stage of the economic cycle.

As stock markets around the world go about describing peak levels of security prices, those investors who wish to purchase more securities in order to realize the promised short-term capital gains have found that the sale of real property holdings would be advantageous. Short-term liquidity and capital gains may be preferred to longer-term operating profits and capital gains. Due to recent stock market conditions, short-term realized profits may be preferred to longer-term "paper" profits.

Real estate holdings normally fit into the investor's portfolio along with stock, bond, and other investments. Portfolio changes are considered on an ongoing basis, and decisions are made. The U.S. stock market is still reaching new highs each day in terms of the Dow Jones Industrial average. Investors need to make portfolio changes in order to fit their investment objectives.

Mergers and the acquisition of companies involved in international income property investment have occurred due to the recession. Portions of the stock of income property development companies have been acquired by foreign real estate investment companies. For example, the majority interest in Ernst Hahn & Associates, a California-based development firm, and a minority interest in The Rouse Company, a Baltimore-based development company, have been purchased recently by large Canadian development companies.

As real estate brokerage firms have consolidated and closed selected branches, development firms have consolidated on an international scale. The formation of larger international development companies has tended to counteract the increased development competition from institutional investors. Many institutional investors in the past have sat back and financed the various kinds of mortgage debt and leases associated with land development. Recently, many of the large investors have created their own development staffs, directly competing with companies specializing in land development. Now, to some extent, there is more balance between the power of the developers and that of the institutions. Changes in competition usually bring about changes in institutional forms and financing methods.

As construction costs have risen and good sites for profitable new buildings have disappeared in the recessionary period, many investors have renovated existing premises instead of constructing new premises for investment return. Income property rehabilitation may mean higher rents and lower operating costs after it is completed. The value of the existing building may increase with the minimal investment in renovation and modernization. Some tax codes and building regulations have encouraged rehabbing over new construction in recent years. Historic structures may be preserved and still generate income through the rehabilitation process. Sometimes renovation merely saves the historic facade and some of the building shell, while the rest of the historic building is gutted for new partitions, equipment, and energy conservation heating and ventilating systems. Extensive structural rehabilitation continues to occur in Paris, Amsterdam, Edinburgh, London, Heidelberg, and Rome as well as U.S. urban centers.

### **Trends In Investment Yields, Risks, And Building Costs**

As the cost of borrowed money rose during the recession of the early 1980s, property investment yields rose also. The cost of borrowed money has risen with inflation. Since the rate of inflation is related to the productivity and the monetary and fiscal policies of the particular country, national rates of inflation during the early '80s have varied widely. For example, inflation rates in Israel and Brazil are over 100 percent a year while inflation rates in the U.S. and West Germany are approximately 5 to 6 percent. The rate of inflation in France has been running around 24 percent a year.

Part of the rise in yields has been associated with the greater overall risk reflected from the international markets. Michael Behar of TFT International of Paris compiled a visual analysis describing the risk dimensions of various countries with respect to the key factors in industrial location decision making (see Table 1). The 1983 risk measurements compared to those in 1980 show an increased overall risk on economic, financial and political bases. For example, many countries moved from the northwest quadrant that reflected high economic and financial and low political risk to the northeast quadrant



that reflected high economic, financial, and political risk. Investment yields resulting from locational decisions should be higher according to traditional financial thought, in order to compensate for the higher investment risks.

Income property yields change over time within a single country. The yield performance figures for income-producing properties in France, that was drawn up by the London firm of Weatherall Green & Smith, show increasing yields for office, retail, and warehouse properties from December 1980 through March 1983 (see Table 2). In general, provincial property yields are higher than yields from comparable properties located in Parisian suburbs or central Paris. Yields are lowest in income properties in central Paris, regardless of the time period shown in Table 2. In 1983 central Paris rents have been higher than rents from comparable properties in provincial cities of France (see Table 3).

From Tables 3 and 4 one may view "property market indicators" for a number of countries and a number of urban centers within each country. Office prime yields were highest in Italy in early 1983. Retail property yields were highest in France and Spain (see Table 4). At the same time, the industrial property yields were highest in Holland, the U.S., and France. The highest office and retail rent per square foot was estimated in New York. The highest industrial building rent per square foot was located in Zurich, Switzerland. Since it is difficult to make yield, cost, and rental comparisons due to market, measurement, building and location differences, these comparisons should not be granted the aura of absolute accuracy, but should be seen as the expressed opinion of two of the well-recognized international real estate consulting and brokerage firms.

**TABLE 2**

Yield Rate Performance for France

	December 1980 %	March 1982 %	March 1983 %
<b>Offices</b>			
Central Paris	6.00-7.00	6.50- 7.50	6.25- 7.25
Paris suburbs	7.75-8.00	8.75- 9.75	8.50- 9.50
Provinces	8.50-9.00	9.50-10.25	9.50-10.50
<b>Shops</b>			
Central Paris	7.00-8.00	8.00- 9.00	8.00- 8.50
Paris suburbs	7.00-8.00	8.00- 9.00	8.50-10.50
Provinces	8.00-9.00	9.00-10.25	9.25-10.75
<b>Warehousing</b>			
Paris	9.75	10.00	10.00
25 kms from Paris	10.00-10.25	10.25-10.75	10.75-11.25
Provinces	10.50-10.75	11.00-11.50	11.50-12.25

Source: France, *Weatheralls Property Report 1983* (London: Weatherall Green & Smith, 1983), 32.

### Reasons That Worldwide Yields Tend To Differ

Quoted yields related to income properties throughout the world differ from each other for a number of reasons.

One reason is the multiplicity of formulas and techniques used for real estate investment yield measurement. Other reasons are related to accounting differences and differences in investment perspectives. Some countries view real estate investment as relatively short term, whereas in other countries the majority of income property investors think very long term with buy-and-hold perspectives.

Another reason for the differences in quoted yields in regard to worldwide income properties is derived from the inherent investment differences exhibited by the various types of income properties. For example, properties with indexed or periodically renegotiated leases exhibit less financial risk for the investor than properties that have fixed base leases with investor participation in tenant gross or net income. The yields associated, therefore, with the two types of leased properties may be quite different. Another reason for the differences is the scarcity and oversupply conditions of property in specific markets.

### *The Multiplicity of Investment Measurement Methods*

Using the U.S. income property market as an example, one finds many methods of income property yield measurement. It is traditional for U.S. investors to use the payback, average rate of return on average investment, and the cash-on-cash methods of yield analysis that do not involve the time value of money. Three methods of analysis utilizing the time value of money and increasingly used today are: 1) net present value, 2) profitability index, and 3) internal or discounted rate of return.

Just mentioning a yield for an income property means nothing. The person conveying the yield information and the one receiving it must identify and understand the method used for the quoted yield measurement. Measuring the yield on one income property by the six methods cited here leads to six different numerical responses. Therefore, any quote of investment yield must indicate the method of yield measurement.

### *Accounting Differences*

In the U.S., many investment yields are based on historic costs which may have been incurred some time ago. The accounts for the income property are usually kept on an historic cost basis. Only recently has market value accounting been utilized by a few U.S. firms for investment market quotations and security disclosures. For example, life insurance companies and commercial banks that are selling their investment management services and yield results to prospective pension fund clients tend to keep their property market values current for the year. Otherwise, historic cost accounting is used for other purposes. In contrast, property accounting in England and the rest of Europe, and in other parts of the world, often is based on market value, not historic value or original cost. Therefore, the yield calculations differ measurably.

### *Differences in Investment Perspectives*

When an institutional investor buys a property, the institution may expect to hold the property indefinitely. There may be no reason to expect an early sale in 5, 20, or 60

**TABLE 3**

Property Market Indicators: Rents per square foot per annum

Country	City	Offices sq. ft.	Shops Unit	Industrials sq. ft.
UK	London	30.00	120,000	3.50
	Birmingham	6.50	52,000	2.20
	Manchester	5.00	35,000	1.90
	Edinburgh	4.50	80,000	1.85
	Glasgow	5.50	67,500	1.85
Belgium	Brussels	3.80	44,000	1.65
	Antwerp	3.30	35,000	1.45
France	Paris	12.40	103,000	2.80
	Lille	3.90	19,500	1.70
	Lyon	4.20	20,000	1.70
	Marseille	4.30	19,500	1.90
Germany	Munich	7.25	65,500	2.15
	Dusseldorf	8.70	65,500	2.30
	Frankfurt	10.20	61,000	2.30
	Hamburg	7.50	57,000	2.20
Holland	Amsterdam	6.60	34,000	2.00
	The Hague	6.00	33,000	2.00
	Rotterdam	5.50	33,000	1.90
Italy	Rome	7.70	23,000	1.30
	Milan	8.60	23,000	2.05
	Turin	5.60	14,000	1.45
Spain	Madrid	7.70	25,500	1.05
	Barcelona	5.60	21,000	0.75
Switzerland	Geneva	12.40	102,000	3.40
	Zurich	17.70	110,000	4.15
USA	New York	27.00	157,000	3.00
	Atlanta	8.80	20,000	1.40
	Boston	17.60	33,000	2.50
	Chicago	14.50	36,000	1.90
	Houston	15.10	28,000	2.20
	Los Angeles	18.20	26,500	2.20
	San Francisco	22.60	94,000	1.90
	Washington, DC	16.30	33,000	2.50
Australia	Sydney	14.30	83,000	2.30
	Melbourne	9.70	78,000	1.90
	Adelaide	5.70	83,000	2.15
	Brisbane	8.00	83,000	2.60
	Perth	9.70	43,000	1.70

**1. Offices**

Rents are based on first class suites of 5,000 sq. ft. in the principal town(s) and modern schemes in excess of 20,000 sq. ft. with good specification in the provinces.

**2. Shops**

Rents are based on a standard shop unit having a frontage of 20 ft. and a depth of 60 ft. with storage/staff accommodation of 300 sq. ft. The total area is 1,500 sq. ft. and the unit is situated in the best position in the town.

**3. Industrials**

Rents are based on single story 15,000 sq. ft. industrial/warehouse units

of steel portal frame or concrete construction with an eaves height of at least 18 ft.

**4. Rents**

Rents are exclusive of rates, service charge and local taxes with the exception of the USA and Australia.

**5. Industrial Rents**

The industrial rents for Belgium, France, Germany, Holland, Italy, Spain and Switzerland have been weighted as the ancillary office space commands a higher rent than the industrial space. The weighting assumes an office content of 10% of the total area.

Source: International Property Bulletin, March 1983 (London: Hillier Parker May & Rowden), 3.

**TABLE 4**

Property Market Indicators: Prime Yields and Building Costs

	UK	Belgium	France	Germany	Holland	Italy	Spain	Switzerland	USA	Australia
<b>Prime Yields %</b>										
Offices	4.75	7.5	7.0	6.0	8.5	7.0	10.0	2.5	9.5	6.5
Shops	3.85	8.5	10.0	5.5	8.5	6.0	10.0	3.5	9.5	7.5
Industrials	7.00	9.5	10.5	8.0	11.0	9.0	12.0	6.0	11.0	9.5
<b>Building Costs</b>										
<b>Offices</b>										
Cost £ sq. ft.	60	26	30	53	37	30	37	52	36	40
Fees as % of building costs	15	15	22.5	15	11	20	20	20	25	16
<b>Shops</b>										
Cost £ sq. ft.	30	21	21	48	24	26	28	31	23	16
Fees as % of building costs	12.5	15	22.5	15	11	20	20	20	25	16
<b>Industrials</b>										
Cost £ sq. ft.	15	8	10	16	12	11	16	21	13	13
Fees as % of building costs	10	15	20	12	10	10	20	17	25	16
<b>Cost of finance % p.a.</b>	9	15	17	8	10	24	17	8	15	18
<b>Exclusions: Items excluded from floor space as defined for rental purposes</b>										
<b>Shops/Offices</b>										
Structural walls	X	X	X	X	X	X	X	X	X	X
Stairs	X		X	X	X	X	X	X	X	X
Lifts	X		X	X	X	X	X	X	X	X
Toilets	X									X
Entrance lobby	X	X	X	X	X	X	X	X		X
<b>Industrials</b>										
Structural walls	X	X	X	X	X	X	X	X	X	X
Stairs			X			X	X	X	X	X
Toilets										X

**1. Building Cost for Offices**

The costs are based on 30,000 sq. ft. self-contained, air-conditioned buildings in the major city in each country. The accommodation is built to a good finish to include false ceilings, carpets, lighting and power points but excluding partitioning.

**2. Building Cost for Shops**

The costs are based on a standard shop unit of 1,500 sq. ft. built as part of a parade, with either office or residential accommodation above, but not in a major covered shopping center. It is constructed to a shell finish and excludes the shop front.

**3. Building Cost for Industrials**

The costs are based on a single story unit of 30,000 sq. ft. of steel portal frame or concrete construction with an eaves height of at least 18 ft. It is finished to a basic shell, with services and heating to the 10% office space but not to the industrial/warehouse area.

**4. UK Cost of Finance**

The figure given is based on the assumption of a forward funding by an institutional investor.

**5. Prime Yields**

Figures given are the net returns received by the investor for prime properties.

Source: International Property Bulletin, March 1983 (London: Hillier Parker May & Rowden), 4.

years, due to tax or cash flow. Therefore, the reversion or resale values often considered by shorter term investors are of no consequence to the institutional investor. If the sale of the acquisition is expected in 50 years, then the present value of the cash flow expected in 50 years will be miniscule using present value tables. The investor concentrates on the operating cash flows to the exclusion of the reversion value. Quite often, the financial institution is not subject to federal income taxation or is subject to far less than regular corporate federal income tax rates.

The taxable investor usually considers the tax impact of operating income and expected reversion values. The approved tax method of recapturing the capital has a bearing on the expected tax consequences of the property acquisition and the expected year of sale. When tax-sheltered income no longer covers principal repayment on the mortgage loan, the income property may be sold. This timing depends on the methods of depreciation permitted by tax authorities for the type of property. (The federal income tax authority in the U.S. is the Internal Revenue Service; in many other countries,

the comparable agency or authority is the Inland Revenue.)

Since the sale of the income property will probably occur in the near future, the reversion value after capital gains tax treatment will be an important part of the investment yield calculation. On a present value basis, a sum of money received from the property sale seven years down the road will have a significant current dollar value.

#### *Differences in Property Investment Characteristics*

The various types of income properties have different investment characteristics. Even within a property investment type, leasing contracts may exhibit very different terms. Office building leases, for example, are usually indexed wherever the building is located. The index selected for the lease contract may differ between tenant contracts, buildings, and among the various countries. For example, the index may be the Consumer Price Index (CPI) which is different for France than the same labeled index in Italy, West Germany, or Ireland. Instead of the CPI, the index may be a cost of funds index for a type of financial institution.

Shopping center leases may be either net leases with building owner participation in gross or net income, or they may be indexed or renegotiable every year, every three years, five years, or some other period of time. The reappraisal lease term may cover any time interval.

Apartment leases are usually not indexed but are net leases in regard to utility expenses. Office building and shopping center leases worldwide also tend to be totally net leases. Changes in apartment leases are often subject to rent control regulations whereas changes in office building and shopping center leases are rarely affected by this type of regulation. When commercial rent control is implemented, it usually lasts only for a short time under emergency economic conditions, such as in England in the early 1980s when inflation in office rents was considered excessive. Commercial rent control exists today in a few U.S. cities; its spread does not appear probable.

The lease contract may be peculiar to the tenant of the building. The landlord and the tenant often negotiate the terms of the individual lease. The landlord-tenant negotiation may bring about lease differences between buildings of comparable land-use in similar locations.

#### *Demand and Supply Differences in the Various Income Property Markets*

If government planning authorities and land-use regulators have a tight hold on the income property market, rents and the cost of building operation and construction may differ from revenues and the cost of building operation and construction in areas where government land-use controls are less formidable. For example, due to construction quality control standards in West Germany, income property construction costs are higher than they are in less regulated areas. The French government closely controls commercial rents on the grounds of consumer equity. Constant lawsuits brought by tenants

have resulted in rent reductions and adjustments to what would be dictated by indexing formulae in the leases. Since the building tenant in France may acquire tenure rights after nine years of occupancy, rents may not rise as rapidly as operating costs which are subject to little control. Housing tenure is a housing demand and supply dimension in the United Kingdom just as commercial tenure is a commercial investment dimension in France.

If the government holds a strong planning and regulatory control over property development, the supply of new commercial space may be held back due to a lack of government approval. The scarcity of commercial space tends to drive rents up for existing space. If suburban development is not allowed, then the inner city commercial space may be more densely used, resulting in the rehabilitation of existing buildings and addition of higher floors. The investment return on monies invested in building renovation and rebuilding are often significant. Many investors feel that the rehabilitation of existing shopping centers, office buildings, apartment buildings, and industrial buildings is advantageous.

If the government owns a lot of land in valuable downtown locations, the ground rent may be subsidized with respect to normal private ground lease provisions. The government may establish ground rents to encourage various types of development and redevelopment. Thus, differing land costs and rents affect yield measurements.

### **Yields With Respect To Worldwide Economic Conditions: Prospects For The Future**

#### *Yield Measurement Methods*

A number of methods for real estate investment yield measurement exist today and more are sure to be explored in the future. Regardless of the methods in use, any indications of achieved investment yields should indicate the method of yield measurement. For example, the methods of yield measurement in Tables 2 and 4 are not mentioned anywhere in the illustration. One may ask, then, how meaningful are the indicated yields? Also, may the reader's yields from personal or business real estate investments be compared to the table yields? The answer is that valid comparisons can be made if the same measurement techniques and methods are used by both the researcher and the reader.

#### *Computer Use*

More and more real estate firms throughout the world use computers for investment analysis. Computer calculations can be done quickly, and yields may be calculated by using a number of investment yield methods. More investment yield information will be made available in the future "information explosion."

#### *Comprehensive International Data Banks*

Each year more investors and consultants analyze worldwide investment data and many of them have established a basis for this valuable data bank.

### *Income-Expense Conditions*

Income property yields change according to the worldwide economic conditions. Income property income and associated expenses fluctuate with the economic cycle experienced throughout the world. Of course, the severity of the recession or the pervasiveness of economic prosperity depend upon which country is operating in the international sphere of business. Each country reflects its overall state of the economy even though most nations are affected by the status of international trade and money flows.

Generally, the international real estate data banks will indicate the squeeze between income-property income and expenses during recessions and the widening of the profit differential between income and expenses during prosperous business periods. The yield picture tends to change over time depending upon the state of the world economy and that of the economy of the particular country where the income property is located. Political, economic, and financial changes affect the profitability of individual income properties throughout the world.



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