

## REAL PROPERTY. REAL RETURNS.

### HOW DO THESE RETURNS ADD UP?

As a follow up to the REAL PROPERTY REAL RETURNS seminar, an exposition of how the different types of returns add up to the total returns would be helpful.

You'll remember that there are five types of returns in these investments:

- 1) Preferred, cumulative cash returns,
- 2) excess returns,
- 3) tax savings (or, in some cases, tax sheltering)
- 4) return of capital from any future mortgage refinancing, and
- 5) a capital gain on a future sale.

For demonstration purposes, let's try to look at some of the financial information shown in the financial statements of one of the investments and see if we can extract the numbers that represent these types of returns.

We'll use a very simple income investment like *McCall Lake Plaza Limited Partnership*, a retail plaza in Calgary, and the information taken from the promoter's financial projections at pages 4, 5, 6 and 8 of the Executive Summary. The Executive Summary can be downloaded from this link (Please request us to send it to you directly if you have any difficulties with the download):

<http://www.londonpier.ca/investmentproperties/WaldenVillageExecutiveSummary.pdf>

In the McCall Lake investment:

- 1) The **preferred returns** for McCall Lake are set at 9% per year, and are not accrued but are paid from the commencement of the investment. The annual amount paid to all limited partners in total is \$153,000 (9% of \$1,700,000), and this number is shown in the 6<sup>th</sup> line of the *Projected Statement of Cash Flows* on page 4 of the Executive Summary.
- 2) The **excess cash flow** is projected to commence in Year 3, and to continue through Years 4 and 5 of the five-year projection. It is shown in the 8<sup>th</sup> line of the *Projected Statement of Cash Flows* (Nil in Years 1 and 2, \$34,454 in Year 3, \$25,887 in Year 4 and \$38,407 in Year 5). These excess returns bring the annual cash returns up from 9% to 11% in Year 3, 10.5% in Year 4 and 11.2% in Year 5.
- 3) **Tax Savings:** While there is no tax *shelter* component in this particular example<sup>1</sup>, the tax payable by an investor on the returns in the first three to five years will be negligible. Tax payable by each limited partner in any year will be based on the partner's share of partnership income for the year, not on the cash distributions received. See the Net Income for the Year shown in the *Projected Statement of Income* at page 6. This compares very favourably with interest-type investments, where the interest received is fully taxed.

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<sup>1</sup> Tax *sheltering* of other income, as opposed to *tax savings*, is typically provided by the retirement residence investments.

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- 4) The **return of capital based on a refinancing** can be expected to occur at the end of Year 5, when a new mortgage would be arranged based on the market value of the property at that time. The Note to Financial Statement at page 8 of the Executive Summary shows the potential value of the property at the end of Year 5. It is based upon a projected market value of the property using three different possible capitalization rates: 10%, 9.75% and 9.5%. Below, I show an extract from that Note to Financial Statement, showing the result using only the 10% capitalization rate (which is the most conservative of the three scenarios).

### McCALL LAKE PLAZA LIMITED PARTNERSHIP

Note to Financial Statements – January 1, 2005 to December 31, 2009

#### Potential Value End of Year 5

The following reflects the value of the property at the end of Year 5 which should allow for an upward refinancing of the project. The value is based on a 10% capitalization rate of gross rents. A 10% capitalization rate is reflective of the market value of the property.

Gross Revenue		594,448 <sup>2</sup>
Selling price based on 10% capitalization rate		5,944,500
Closing costs - 2.5%		(148,600)
Available cash net of tenant deposits		24,525
Repayment of debt		(3,240,132)
Repayment of Capital		(1,700,000) <sup>3</sup>
Available for distribution		880,293
Allocation:		
Manager	37.50% <sup>4</sup>	330,110
Limited Partners	62.50%	550,183
<i>Add preferred return and excess cash flow</i>		
Year 1		153,000
Year 2		153,000
Year 3		187,454
Year 4		178,887
Year 5		191,407
		1,413,932
Annualized Return (simple interest)		<b>16.6%</b>

At a 9.75% capitalization rate, the total proceeds of sale/refinancing to limited partners are shown as \$1,506,807 and the annualized combined return as 17.7%; at a 9.5% capitalization rate, the proceeds are \$1,604,557 and the annualized combined return, 18.9%.

<sup>2</sup> Year 5 Revenue shown in Projected Statement of Income, Line 1.

<sup>3</sup> Repayment to limited partners of their entire original capital investment out of proceeds of a sale is shown in order to calculate the excess proceeds that would be earned on a sale.

<sup>4</sup> The "Back End Split" formula varies among different investments. In McCall Lake, it is 62.5% to the limited partners, 37.5% to the general partner.

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**Capitalization Rate:** Buyers purchase property on the basis of a capitalization of the expected future stream of revenue. A capitalization rate of 10% means the buyer is paying a price based on an expectation that the capital invested will earn 10% per year in future.

For these types of properties, real estate appraisers look at the market prices that are being paid to purchase properties of a similar type in a given market and at the revenue being generated by each of those properties. From those data, they calculate a capitalization rate for that type of property. Using the appropriate capitalization rate and the projected revenue for a target property, appraisers calculate a market value. Mortgage lenders rely on such appraisals of market value when making mortgage loan decisions.

A capitalization rate of 10% has been found to reflect the market value of properties similar to the McCall Lake Plaza, and this is applied to the projected revenue for Year 5 to calculate a potential value for the property at the end of Year 5.

**Calculation of the Overall Return:** Notice that the limited partners' share of the excess proceeds of sale is \$550,183 after both the prior existing mortgage has been repaid and the partner's original capital has been returned. Finally, the amounts of all cash distributions paid over five years are added to the limited partners' share of excess proceeds of sale. The total of all these returns is divided by 5 years in the calculation of an annualized simple interest return.

Usually, not all of the original capital is returned at the time of the first refinancing, as certain amounts must be retained for working capital and other reserves.

- 5) While the **future capital gain** on the basis of a sale taking place beyond Year 5 is not projected, the calculation for the distribution of excess sale proceeds in the event of an actual sale of the property would resemble that shown in the Note to Financial Statement. Any residual balance of capital invested would likely be repaid out of the proceeds of a sale, as would the limited partners' share of further gain in value that would accrue between the time of the refinancing and the time of the ultimate sale.

### Summary:

In this example, over the five years of the projection, the 9% preferred cash returns are paid quarterly to investors, while the projected excess cash returns are paid in Years 3, 4 and 5 for combined annual *cash* returns in those years of 11%, 10.5% and 11.2%, respectively (see the *Projected Statement of Cash Flows* at page 4).

The tax payable by limited partners is based on the projected income earned by the partnership, and is nominal in the first three to five years. Capital gains tax on the limited partner's share of the gain in value will not be triggered until the property is sold, even when some of the gain enables a return of capital in the meantime.

A projected sale of the property at the end of five years, using a capitalization rate of 10% and the projected revenue for Year 5, shows that after repayment of debt and return of all capital to investors, the amount available for distribution to the limited partners would be \$550,183. Adding the total of all cash returns paid over five years shows the total projected returns of \$1,413,932. The simple interest annualized rate of return over the five years is therefore 16.6%

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using a 10% capitalization rate, 17.7% using a 9.75 capitalization rate and 18.9% using a 9.5% capitalization rate.

Applying the 16.6% rate of return, a single investment of \$50,000 grows to \$91,586.

Limited Partner's share of proceeds of financing or sale	62.50%	16,182
<i>Add preferred return and excess cash flow</i>		
Year 1		4,500
Year 2		4,500
Year 3		5,513
Year 4		5,261
Year 5		5,630
Total Returns		<u>41,586</u>
<i>Add Limited Partner's Capital</i>		
		<u>50,000</u>
		<u><b>91,586</b></u>