Cuffelinks
Connecting investors with ideas

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What real estate agents don't tell you

Graham Hand

Explore the rear entrance of an apartment hotel or resort that is more than five years old and take a look at the contents of the skips in the lane outside. They are often full of sofas, dining chairs, mattresses and televisions. Seven years earlier, when the proposal for a shiny new building was just a model in a display apartment for off-the-plan sales, hundreds of dreamers signed up to buy apartments. They also agreed to a furniture package for $40,000 to allow the building to operate as a hotel or resort. After years of people on holidays staying in the rooms, jumping on the sofas and leaning back on the chairs, the furniture needs replacing. Over the five years, that's another $8,000 a year of costs to write off for each owner. It's not such a dream now.

A few years later, the apartment will probably need a new bathroom and kitchen. How many years of income will that cost?

If you don't believe a sofa lasts only five years, you've probably never owned one of these short-let apartments. Hundreds of kids and honeymooners and party animals have jumped all over the furniture while on holiday. Have you ever watched coverage of schoolies week?

The most misleading number in investing

Real estate agents quoting gross yields on residential property are using the most misleading number in investing. The costs associated with residential property consume most of the income, leaving uninformed investors blind to the actual returns until the expenses start to come in. In an era where the professionalism of financial advisers is slammed daily in the media, many property agents get away with poor disclosure without comment.

Obviously, this is not a marginal asset class few people care about. Residential real estate in Australia is worth $5.8 trillion, and it dwarfs listed equities of $1.6 trillion and superannuation of $2 trillion. It

accounts for over half of Australia's wealth (see Corelogic Housing and Economic Market Update, April 2015).

Why are gross versus net yields so important for real estate?

Invest in a term deposit at 3% and you will earn 3%. There are no other costs involved. In equities, the effective dividend yield earned can be better than the quoted rate when imputation credits are added back. But residential property is the opposite. Net yields should be the main focus because expenses are high and unavoidable, even if the property is left empty.

A typical commentary on a real estate 'entertainment' programme goes like this:

"Is this a buy or a sell? It's a one-bedder only 10 kilometres from the centre of Sydney, close to buses, 65 square metres, asking $750,000, would rent for $650 a week."

"Well, the starting point is you don't want to be out of this market," replies the agent confidently. "This place will be worth $50,000 more in a year – that's $1,000 every week. And look, $650 a week is about $35,000 a year, that's a yield of 4.5%. Where can you get that today?"

Can you imagine what ASIC would do to a licensed adviser who spoke like that, or included it in an offer document? Prices do not always rise, and that yield is not available by buying that apartment.

CoreLogic quotes rental rates of 3.7% for 'combined capitals' across Australia, but this number is gross rental yields (for example, see page 7 of above-linked report). It's the number the industry loves to talk about. But even if we put aside stamp duty, legal costs, borrowing costs and vacancies, what about the regular costs of owning a property? These are the ongoing drains on income that are often overlooked. According to a Reserve Bank of Australia Research Paper, 'Is Housing Overvalued' (June 2014), the running costs of long term rental properties are 1.5% per annum, and transaction costs of 7.3% averaged over ten years are 0.7%, giving costs of 2.2% per annum.

That takes the net yield to 1.5% before allowing for repairs and maintenance. Reality is completely different than the real estate brochures and entertainment programmes convey.

How do management rights work?

When a large apartment building is constructed, the lots or units are purchased either by people who want to live in them (owner occupiers) or let them (investors). The 'management rights' to the building are sold by the developer, which gives the manager the right to charge a fee to look after the building and in some circumstances, run a letting scheme. The manager estimates how much income the building can generate when deciding how much to pay for the rights.

Of course, there are hundreds of thousands of different schemes in Australia, ranging from small premises run by mum and dad to professional managers (including listed companies) who may pay up to $15 million to manage a large, prestigious building by the beach with great views. The management rights might include running a restaurant, a reception centre, housekeeping, a real estate business as well as the letting and maintenance. Income includes payments from the body corporate, plus owners who enter a letting agreement pay a percentage of the letting charges, say 8% for long term letting and 12% for short term. The vast majority of apartment buyers in a hotel or resort sign up with the manager because there are efficiencies in one person managing the whole building. But what the buyer does not realise is that every change of a light bulb, every adjustment of the remote control, and every time the room is cleaned is a money-making opportunity to recover that $15 million.

Higher income, higher expenses

An apartment costing say $500,000 might rent permanently for $500 a week, but as part of a hotel, $250 night in high season. How can this not be a better deal? Consider these examples of well-established apartments in hotel or resort schemes targeted at short-term letting:

Table 1: Extracts from tax returns for typical short term letting apartments

Type	Estimated Value	Financial Year	Income	Expense	Net income
1 bedroom NSW	$500,000	2013/2014	$62,475	$46,881	$15,594
		2012/2013	$56,248	$40,083	$16,165
2 bedroom QLD	$500,000*	2009/2010	$20,944	$29,684	-$8,739
		2008/2009	$24,740	$31,388	-$6,648
		2007/2008	$26,631	$31,473	-$4,842
3 bedroom QLD	$350,000	2013/2014	$27,946	$28,018	-$72

*Bought in 2004 for $500,000, sold in 2011 for $505,000 (gross before costs).

The expenses from short term letting are far more than permanent, especially costs such as cleaning and replacing equipment. Owning an apartment for short term letting can be an annoying experience of monthly expenses to maintain the apartment to the standard required by the hotel or resort manager. Here is more detail from the tax returns of these apartments:

Table 2: Detailed income and expense returns

Income or Expense	3 bedroom QLD	2 bedroom QLD	1 bedroom NSW
Rents received	$27,946	$20,944	$62,475
Expenses			
Advertising for tenants	$922	$264	$3,124
Body corporate fees	$6,246	$7,309	$8,247
Cleaning	$3,693	$4,099	$15,568
Council rates	$1,458	$3,521	$936
Depreciation on plant	$1,422		$2,123
Insurance	$931		
Property agent fees	$3,689	$8,683	$8,205
Repairs and maintenance	$671	$4,793	
Special building write off	$1,772		
Water charges	$1,666		$694
Linen	$2,419		
Electricity	$1,121	$834	
Total expenses	**$28,018**	**$29,684**	**$46,881**
Net rent	**-$72**	**-$8,739**	**$15,594**

(Tax returns do not use the same categories in every case).

It's hard to believe a small apartment can incur $47,000 in costs a year. People who put their apartments into these letting pools are probably prepared for some of the same costs as long term rentals, such as strata fees and council rates, but who expects regular costs such as these:

Table 3: Examples of specific expenses in short term letting

Typical Expenses	Amount
Cost of cleaning one-bedder after a one night stay	$73.32 per night
Assist guest to use air conditioner	$13.68
Fixed bath tap and repaired toilet roll holder	$27.35
Fixed oven	$13.68
Dry clean doona	$64.90 regularly
Dry clean blanket	$43.78 per month

Fixed loose dining table	$13.68
New knife	$20.00
Cable TV	$47.85 per month
PABX	$30.53 per month
Replace blown light bulb	$23.36
Fixed DVD player	$13.68
Pest control	$16.50 per quarter
Repaired bed wheel	$13.68
Fixed fridge and reset	$13.68
Dry clean shower curtain	$26.40 per month
Rehooked curtain	$13.68
Fixed leaking toilet	$27.35
Reset microwave oven	$13.68
Television hire	$37.00 per month
Refit towel rail	$54.00

It's a monthly crap shoot. The owner pays $360 a year for the phone system, and could buy the television for a year of hiring fees. The dry cleaning can be $100 a month. The cost of cleaning a one-bedroom apartment after one night is an unbelievable $73. How long does it take to clean a small apartment in a building with 200 such apartments? If you think the management fee should cover the quick visits to the apartment and complaints by guests, read the fine print. There is no way of knowing how often a light bulb is replaced or a bed cover dry cleaned. Who dry cleans a shower curtain every month? That $1 light bulb costs $23 to replace. This is a big money earner for the manager. A guest might stay for one night and after expenses such as booking agent fees, advertising levy, housekeeping and repairs, little is left for the owner. It's not worth the wear and tear on the apartment.

Who cares, capital gains and tax deductions are more important than income

Many investors may consider the income to be a minor part of the expected return, especially if they realise it's only likely to be 1.5%. Residential property prices in Sydney were up 14% in the year to March 2015, so a few dollars in expenses is tolerable (although it was less than 5% per annum for the decade before 2015).

There's a problem here as well with short term letting. Most owner occupiers do not want to live in a building where the majority of other tenants are holiday-makers. These visitors are out to have a good time. They party late at night, crash their suitcases into the lifts and walls, drag their wheels across the floorboards or carpets, return from the beach in their towels and drip on the furniture. The kitchen benches get scratched, the carpet must be cleaned regularly and equipment is stolen. People who assume guests look after the room in the same way they look after their own home don't know how some people live. A permanent resident living in a building does not want to battle a lift full of suitcases every time they leave their apartment.

So the secondary market sales of these apartments are usually not to owner occupiers, and the building gradually becomes dominated by short term lets. The major buying force that pushes up the price of real estate, the person buying their dream home, is not in the market. The premises are also subject to intense wear and tear, and the foyers are full of holiday brochures and bags and screaming children and people waiting to check in or out. So these apartments are worth less than in owner occupied buildings. Investors ask to see the net return after five years, the tired furniture and dirty carpet, and the income yield is not enough to create demand unless the price is relatively low. In many locations, these apartments in hotel schemes are the cheapest in town. It's no surprise the two-bedder listed above made a large capital loss after expenses (stamp duty, agent's fees, legal fees) despite seven years of ownership.

At least the loss is a tax deduction, able to be offset against other income. But buying an asset to create a loss and a tax deduction is a strange way to build wealth. Many investors talk about the 'tax deduction benefits' as if that is a good aim in itself. The only reason it's a tax deduction is because it's a loss.

OK, but at least I can holiday there

How about justifying the purchase by using the apartment once a year for a holiday? Forget it. The time of the year when the rent is the best is also when the owner wants to use it. Don't confuse an investment with a holiday. Anyone who wants a week in a resort should pay for a week in a resort, not a year of problems owning the place.

Graham Hand is Editor of Cuffelinks and is now onto his third sofa in an investment property. He will soon write another article on some of the merits of residential real estate. This article is for general educational purposes about a specific market segment, and individuals should obtain their own professional advice.

Don't treat bank shares as defensive assets

Dr Philipp Hofflin

Residential property constitutes by far the largest asset class in Australia, and on average, property accounts for over two-thirds of Australian households' net worth. If you include investment in the shares of banks, which are themselves heavily exposed to property, the average Australian household has about 70% of its net worth 'at risk' exposure to residential property.

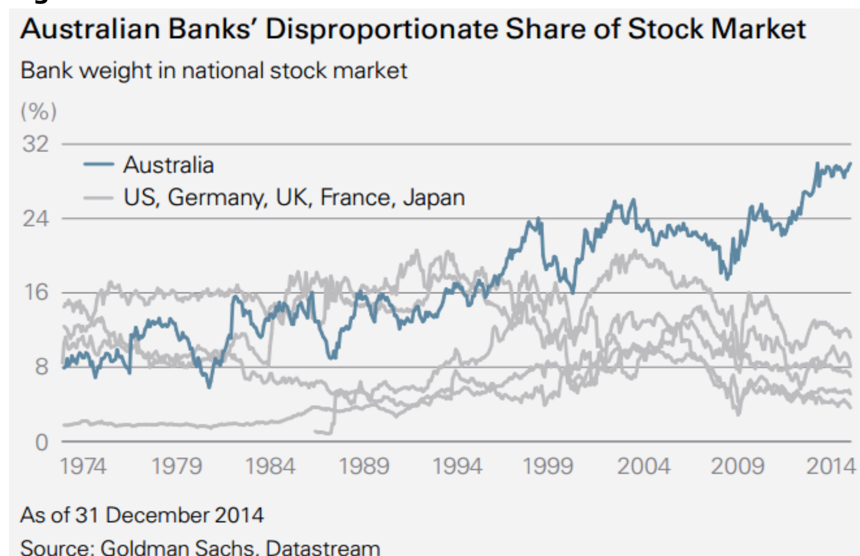
What does this mean for the share market?

Various commentators have recently warned that the market valuations of the four major domestic banks are high. But instead of analysing P/E multiples, low credit losses or high payout ratios, in this article we apply a 'big picture' outside view of the banks.

Australian banks have been outstanding performers from both a revenue and share price perspective. Currently all four major Australian banks (ANZ, Commonwealth, National Australia Bank, Westpac) are among the largest 14 banks in the world by market capitalisation, which is extraordinary given that no German, French, Italian, or domestic British bank is in that top 14. There is one Japanese bank in the top 14, whereas 25 years ago, when the Japanese property bubble was at its peak, nine out of the top ten banks were Japanese. This is not just a question of market concentration — the entire Japanese banking sector value is 20% less than the big four Australian banks together.

Another useful comparison across countries and history is the size of the banking sector relative to the value of all the other listed companies in (Figure 1).

Figure 1:

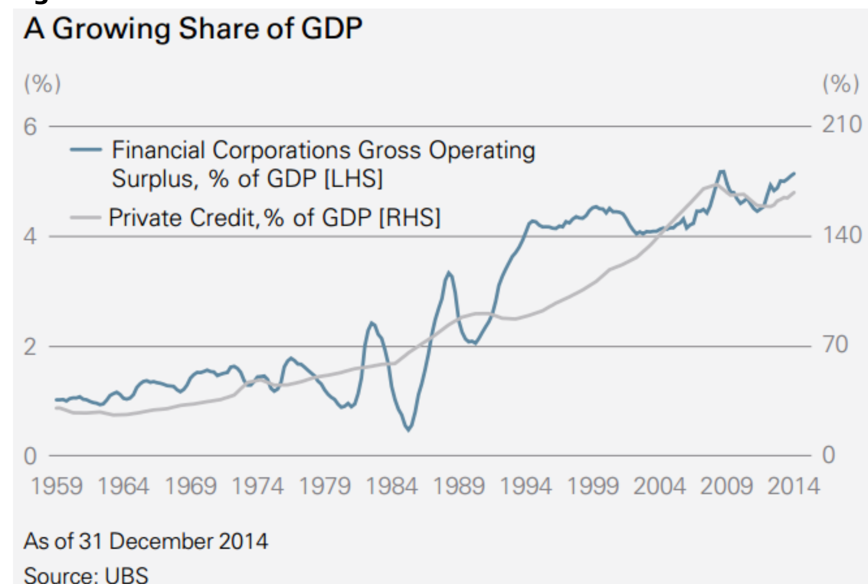


The Japanese banking sector accounted for just above 20% of the market at the 1990 peak of the Japanese debt and property bubble. A similar level of 20% was reached by the UK banking sector at the peak of the pre-global financial crisis boom in the 2000s (though this was enhanced by non-domestic banks, such as HSBC and Standard Chartered, being listed in London). The index weight of Australian domestic banks is over 30%, a level not even reached during lending and property bubbles in markets overseas. It seems reasonable that the value of a nation's (listed) bank sector should bear some relationship to the value of its (listed) national economy. Across the world this ratio is about 1:10; in Australia it is 1:2.

Australian banks do well because there is a lot of debt

Why are Australian banks so highly valued? Put simply, Australian banks earn very high profits. However, this is not because, in our view, they are better run, enjoy better margins, or use more advanced technology, but because there is a lot of debt in Australia. This debt is effectively the top line of a bank's P&L — the more debt, the more net interest and fee income.

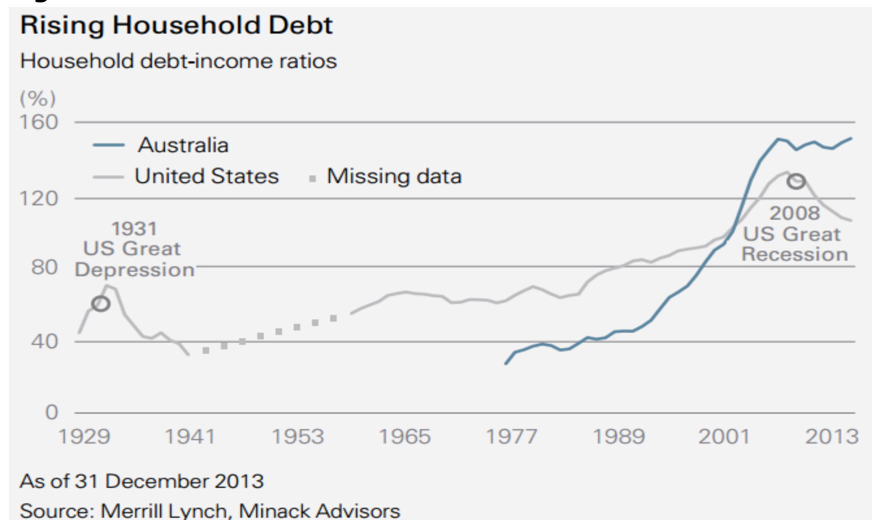
Figure 2:



This relationship is illustrated by Figure 2, which shows financial sector profits (which are dominated by banks) relative to GDP and outstanding credit to GDP. As both quantities are expressed as a percentage of GDP, one might expect a steady ratio. Instead we find that since the late 1950s credit has grown about five fold relative to GDP and so have financial sector profits. In this sense the high valuations of

Australian banks have been driven by the same drivers as in the United Kingdom before the global financial crisis, and in Japan before the bust.

Figure 3:



The household sector has primarily been responsible for this growth in debt, as individuals have increased borrowing to purchase residential property. Figure 3 shows the household debt to income ratio over time for the United States and Australia. We note three features of these developments. Australian household gearing, previously much more conservative than that in the United States, rose very rapidly between 1990 and 2008 and exceeded US debt levels. US households have de-geared since 2008 while Australian households have not, and indeed the latest data show new record highs in Australia. The gap to the United States has thus widened further.

This data is not encouraging, but we note that there have been some positive lessons learned from the US crisis. 'Low-doc' lending, which the banks were just ramping up in the lead-up to 2008, seems to have mostly disappeared, liquidity levels at the banks have improved dramatically, and regulators have insisted on them holding significantly more capital. This does help but to what extent, if the lending and speculative investing continue unchecked? One is inevitably reminded of George Santayana's well-known aphorism that 'those who do not learn from history are condemned to repeat it.'

What to do?

These risks are real, in our view, but we do not know when and how these distortions will be remedied. We are more confident that, in a decade hence, this distortion will be obvious, like so many others before it. In the meantime, however, we face difficult choices. Given the uncertainties, and in particular our lack of information about the timing of any adjustment, how can investors sensibly and prudently proceed?

We describe two actions that can be taken within the context of the Australian stock market:

1. Investors around the world have sought out stocks with sound yields and defensive earnings, focusing on the utility, infrastructure, health care, and telecommunications sectors. However, in Australia (and only in Australia, it seems), this focus has included banks. Given their gearing and exposure to the domestic economy, we do not subscribe to this local view of banks as defensives.

   In our view, however, there are genuine defensives within the Australian market, in the sense that a sharp economic downturn would affect such companies less. These companies may have their own idiosyncratic problems at times, but they can mitigate macro-economic sensitivity within a portfolio. In our view, not all yields are created equal and some are safer than others.

2. There are, furthermore, successful Australian companies that have expanded globally and now run competitive businesses offshore or export to other nations. These companies can act as hedges to the Australian residential/bank exposure because a decline in the Australian dollar, lower wage growth, and spare capacity in Australia would raise the value of these companies. We believe the value of these companies would be enhanced in local currency in the event of a recession finally ending

> Australia's remarkable run of 24 years without a downturn and its associated 24-year run of increasing household leverage.

In closing, we would like to stress that we are not predicting an imminent crash in Australian property prices. However, investors should be aware of the enormous exposure Australians have to this risk and that property and banks are likely to be highly correlated in any downturn. And while we can't predict when these market distortions will start to unwind, we suggest that investors consider treating banks less like defensive holdings and consider domestic companies with global exposure in their portfolios.

Dr Philipp Hofflin is a Portfolio Manager at Lazard Asset Management. This article is general information and does not address the personal needs of any individual. This article is an extract from the longer version and is reproduced with permission.

When seniors re-partner

Alex Denham

I was chatting to a 74-year-old lady, Ms E, recently about her new romance. A long-term divorcee, she is enjoying a new relationship that looks promising, and they are starting to talk about moving in together. She is 74, he 80 - a long-term widower. They have both been independent for a long time, and have their own families with grown children and young grandchildren.

Whilst a new relationship is exciting to someone who has been alone for a long time, Ms E is worried. She owns her house which has a small mortgage on it, and claims a part age pension. She has little else, and supplements her income by taking in boarders. He owns his house outright, and has around $100,000 cash.

"What will happen to my pension?" she asks. "If he moves into my house, what happens if I die? Will he get my house? Do I need to update my will?"

It is a good thing that she's thinking about these matters now rather than later, As we spoke, I realised she was misinformed and harbouring a strong trust in the knowledge of her neighbour. She was quite convinced that she would lose her pension and her house and for these reasons was getting ready to walk away from her new love interest.

She is right to be concerned. Just what ARE the issues to watch out for when seniors or the elderly re-partner? Many – in fact most I would say - would wish to maintain separate financial arrangements at this stage in their lives.

Unfortunately, the law may see it differently. Let's look at the impact on the age pension, and some estate planning issues.

What happens to the age pension if they move in together?

If one or both members of the couple claim an age (or any other means-tested) pension, then the first thing to look at will be the impact. Will Centrelink or the Department of Veteran's Affairs actually consider them a couple? There are several aspects that Centrelink will take into consideration, and you can read more here.

It is possible to request that you continue to be assessed as singles, and these requests are considered on a case by case basis. This may be worthwhile if possible.

Assuming Ms E and her beau are considered to be a couple if they move in together, that certainly will mean a reassessment for both of them. In most cases, this will result in a reduction of their age pension, especially where (as in this case) they both own their own homes.

If he moves into her house, his home, worth around $1 million, will be treated as an investment property and assessed as an asset to both of them. If he rents it out, the rental income will count towards their combined income for the Income Test.

Both will go from being full single rate age pensioners ($860 per fortnight each), to being close to losing the age pension altogether. They will have to live on the rental income from his house and his cash savings.

What if Ms E moves into his house, renting her house out? That's a little better. Her home is worth $700,000 with a $120,000 mortgage, net value $580,000. They will qualify for around $342 a fortnight each.

If they are considered by Centrelink to be singles, the one who moves out of their house will be the one most affected. In this case, the beau would lose his pension altogether if he moves in with Ms E due to the assets test. Alternatively, Ms E would continue to qualify for around $500 a fortnight if she moves in with him.

These questions must be carefully considered. There are other scenarios, such as if they sold one or both of their houses and bought a new place together, or they may rent out their houses and rent somewhere else together. All of them come with their own estate planning issues.

A quick note for those with grandfathered account-based pensions: remember that in order to keep the grandfathering, you must continually qualify for income support payments for the grandfathering to continue. Keep this in mind when sorting through these issues.

Will the new beau steal the house?

The short answer is: if they are living together as a de facto couple, then they may have a claim on each other's estate.

Often the risk of claims occurring do not come from the couple themselves, but from the children of the survivor. Strong influence from an opportunistic beneficiary can be hard for a bereaved elderly person to resist.

The best frontline protection is for the couple to put in place a Binding Financial Agreement ensuring that they have no claim on each other's assets. This may be a little costly with most local lawyers charging at least $300 an hour, but will help to ensure no nastiness down the track, and shoo away those pesky offspring.

In cases where the co-habitation is genuinely just about companionship, living as friends and flatmates, without a Binding Financial Agreement in place it would be up to the courts to decide the status of the relationship in the event of a claim. In this case, a letter signed by both parties kept with the will can be helpful. It would not be the only thing the court would rely on, but serves as a good indicator of the intentions of the couple. How Centrelink is treating them would be another indicator for the courts to consider.

A new relationship is exciting, no matter what age, and now that I've completely ripped the romance out of it, I wish Ms E and the beau many happy years together, comfortable in the knowledge that they have protected themselves, each other and their beneficiaries.

Alex Denham is a Financial Services Consultant and Freelance Writer. This article is general information and does not consider the personal circumstances of any individual and professional advice should be obtained before taking any action.

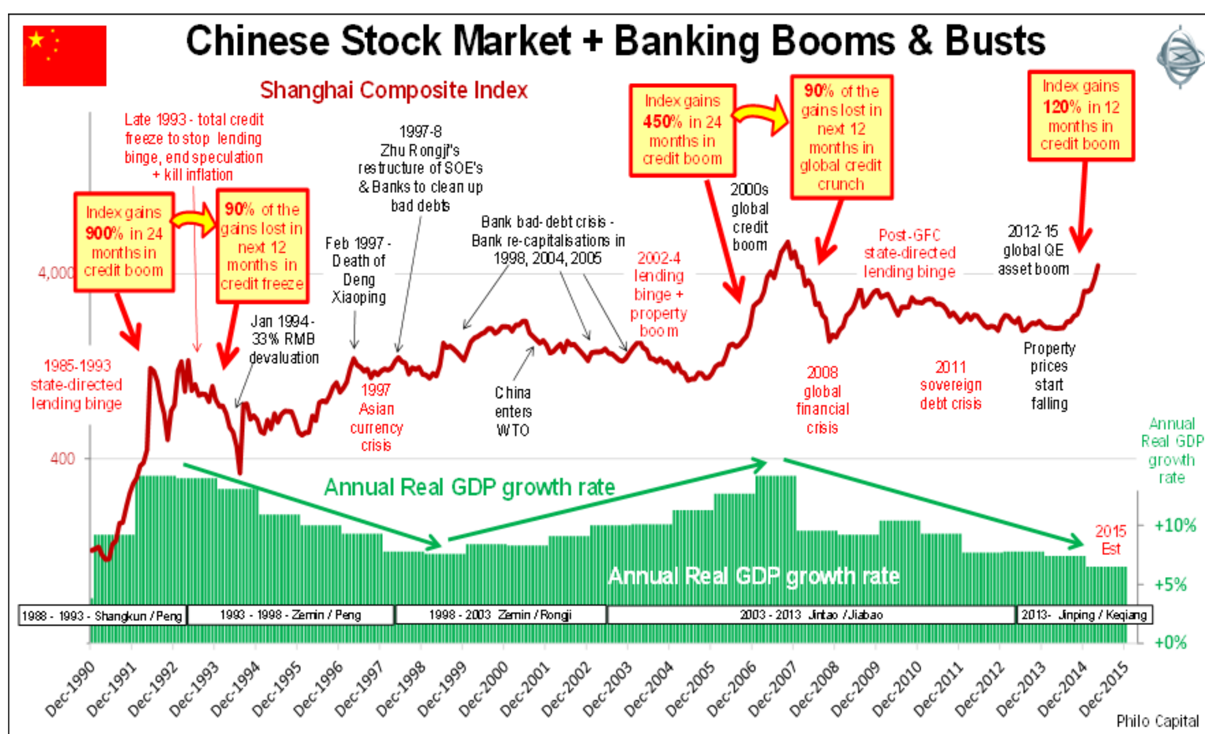
Another stock market spike in China – feeling lucky?

Ashley Owen

So far this year we have seen good returns from all asset classes (except cash), in Australia and globally. Shares are fully priced or over-priced but they are still doing better than their long term averages. Likewise with listed and unlisted real estate. Bonds are horribly over-priced but they too have generated above average real returns.

In a world where everything is doing well for investors something is bound to go wrong. It is impossible to over-weight (or under-weight) everything in portfolios so it calls for tough decisions. How long can the great 2012-15 QE rally last?

Here is a close look at the incredible spike in the prices of Chinese stocks in the last year, linked back to the perennial culprits – banks and the credit cycle.



The Shanghai index has shot up 120% in the past 12 months after five years of falls. Less well known is that this is a rather mild spike compared to past episodes.

There have been two great stock market spikes in post-1949 China. Both were fuelled by credit binges and both promptly crashed when credit dried up. In 1991-1993 the index gained 900% in 24 months but then lost 90% of the gains in the next 12 months. In 2006-2007 the index gained 450% in 24 months, but also promptly lost 90% of the gains in the next 12 months.

There was an orgy of bad lending in the 1985-1993 credit binge by the big Chinese state-owned banks. To end the party the government had to impose a total freeze on lending in late 1993. That crunched asset prices, employment, the economy and the banking system, and it took the next 12 years to clean up the mountain of bad debts in the banks.

As soon as it did, the next great credit/property/stock market bubble took off in 2006-2007, fuelled by cheap credit and geared-up local and global investors chasing the ‘China growth’ story. The boom ended in a crash in 2008 when credit froze as the global banking system seized up.

In the ensuing global financial crisis, the Chinese government embarked on a massive spending and credit spree to support the economy. The bubble re-appeared firstly in housing and then moved on to shares last year when housing prices started to fall. Driving the current boom are cashed-up first-time local punters, many using margin debt, and the spike is now being chased by foreigners eager to get in on the action.

The current stock market rally is quite modest by comparison to past bubbles and pricing levels are still not stretched – for example price/earnings ratios and dividend yields are not outlandish. The market may run up a lot further from here but banks are hiding another mountain of bad debts built up in the post-GFC lending binge, and so this boom will probably end the same way as previous episodes.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is educational only. It is not personal financial advice and does not consider the circumstances of any individual.

Valuations in the tech sector: what's the deal?

Rachel White

Uber - $US50 billion + (and rising quickly)
Snapchat - $US15 billion
AirBNB - $US20 billion
Realestate.com.au - $A6.5 billion
Freelancer - $A500 million

For anyone familiar with valuing assets in any sector other than early stage technology, there is an understandable confusion and mistrust about the numbers listed above. The golden rule of valuations is 'what someone else is prepared to pay for it' and regardless of what analysts in other sectors believe, investments are being made at these valuations, right now.

Have these investors taken leave of their senses, or is there something else going on?

A parallel can be drawn to the residential property market, where houses sold a year ago are back on the market at significantly higher levels. With property, there are both external and internal factors at play. We understand these and we can explain them, even if we shake our heads at the extent of the changes.

Technology valuations are also driven by both external and internal factors, which are less understood. Why? Residential property has been around for a long time, tech has not. It takes time and a lot of transactions for the valuation methodologies to appear and to be well understood.

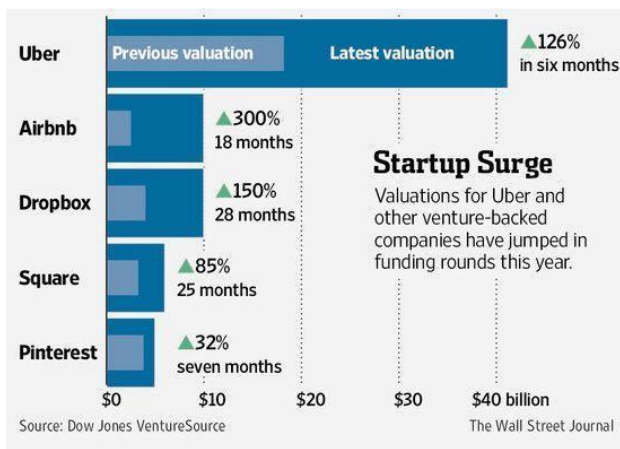
External factors driving valuations

External factors can always be brought back to supply and demand.

From a supply viewpoint, there are more companies than ever starting to appear with disruptive business models. Dropbox did not exist six years ago, but now has a valuation of approximately $10 billion and expected 2014 revenue of at least $200 million, perhaps closer to $400 million.

But for every Dropbox, there are 100 other companies that won't make it. How do you pick the next Dropbox? Insider tech investors know you can't. The investment approach is far more about filtering out those who aren't going to make it, rather than trying to pick the one company that will.

The chart below shows the valuation increments over the last 12 months of major tech companies:



Such incredible valuation changes are driven by two main demand-side factors:

A. Venture capitalists (VCs), in Silicon Valley in particular, are looking for the next Uber (using the current example). They need to invest in just about everything, and once the 'Uber' in their portfolio appears they are then looking for a 200 to 400 times return on that investment.

   This is generally known as 'FOMO' – Fear of Missing Out.

B. The volume of cash now available for early stage investment from VC funds, based on a series of successful exits. This includes the Facebook IPO, Linkedin, the $6 billion that was part of the Whatsapp deal and a series of other high profile transactions.

It is estimated that last year, Silicon Valley VCs invested approximately $46 billion in early stage ventures. They are looking for between $100 billion and $200 billion back, based on their current investment approach.

Will they get this kind of return? They might. If they do, next time around they will invest $200 billion and look for $400 to $800 billion in return, and so on it goes. At some point the bubble will burst and there will be a correction. It is reasonable to expect there to be a reset of the external factors driving valuation in the next few years.

Internal factors driving valuations

The business model is the primary internal factor driving valuations.

Many people have done a business or accounting course and all of the profit calculations were based on the manufacture and sale of widgets. Even the advent of the services based economy has not shifted this.

To understand the technology based business model, a fundamental shift is required to look at profitability from the viewpoint of the customer, rather than the product. While many industries such as fast-moving consumer goods (FMCG) and banking have been doing this internally for some time, it is not part of their external reporting to shareholders.

To understand how a technology business model makes money (or to establish if this is the case), these are the main elements:

- Life time value: this is the total value of revenue expected from that customer, over the life time of that customer
- Customer churn: this is what is used as a proxy of how long customers are staying
- Cost of acquisition: what is the total cost of acquiring the customer, which will be a combination of sales and marketing costs

- Cost of retention: an essential part of any business which is based on long trailing revenue streams, including brand building, account management and customer support
- Cost of delivery: for tech based businesses this is minimal, as the platform does all the 'heavy lifting'
- Cost of running a business: this is the standard office rental, cost of executives or office-holders, investor relations, legal support and other compliance related costs.

This calculates a product yield which is a return on investment for the sunk costs of building the product.

In real estate property management businesses, the accepted valuation method is 3–4 times annual revenue. For tech companies, a multiple of revenue is also used but this has been higher than 10 times for some time.

Why the difference between 3 times and 10+ times? Firstly, the cost of delivery is genuinely minimal, hence the product yield is normally at least 50% of lifetime value. Second, the growth potential if the product is truly scalable, and the founder can find a way to reach the right customers, has no limits as there are no capacity constraints, as evidenced by the rapid global expansion of Uber.

So what's the best way to approach investments in tech companies, and especially those which are pre-cashflow positive?

- The most effective investors are those who are actively engaged in their portfolio. A lot of investor educational seminars are appearing which speak more to this point
- The external factors driving valuation are fickle and can change rapidly. There is a 'herd mentality' that goes with it. A second opinion is always a good idea
- Remember the 'inside' tech investors don't have a magic formula either to pick the winners – hence this part of your portfolio can only be considered speculative
- Ask questions to get inside the business model. Does the founder know how they will reach their customers? Do they know how much this will cost? What is the likely customer retention and engagement cycle? How long will they take to find out if the idea works? Will the money last?

Tech has had some amazing success stories that grab the headlines, but you hear far less about the massive number of failures. There are 1.2 million apps in the Apple store, but we use only seven each on average. The majority go nowhere. It can be a scary ride that's not the place for a big chunk of your retirement savings, but it's also an exciting space to be in.

Rachel White is a partner at corporate advisory firm, Verde Group. This article is for general education purposes and does not address the personal circumstances of any individual.

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