An Example of calculating yield and capital growth

You need to properly understand the financial returns from buy to let in terms of yield and capital growth. If you can't work out these numbers, then you can't:

1. Work out whether a property is worth investing in
2. Compare how different property investments stack up
3. Decide whether to invest in buy to let or another financial investment
4. Evaluate the risks of buy to let investment
5. Calculate your buy to let investment returns

Yield

There are different ways of calculating yield and, to some extent, as long as you're consistent, it doesn't matter which method you use.

Probably the most popular method is taking the annual rent and dividing it by the purchase price of the property, for example:

Annual Rent:	**£8,000**
Property purchase cost:	**£125,000**
GROSS YIELD:	**6.4% (£8,000/£125,000)**

Once you have the gross yield percentage, you can compare potential property investments and see how the properties you already own are performing. You can also compare investments outside the property market and evaluate the risks and rewards against those from buy to let.

For example, if you could get a guaranteed annual gross return (yield) of 7% from putting £125,000 into a savings account, then you might prefer to do that. The upside of a guaranteed savings scheme is that, whatever happens, you will get that return. In buy to let, the 6.4% return can be easily reduced by market forces or void periods, when the property is empty and not earning you any rent. What you miss out on by choosing a guaranteed savings account over buy to let is the potential to gain capital growth.

Capital Growth

This is calculated by taking the value of the property today and taking away the amount you paid for it, for example:

Property purchase price, 10 years ago:	**£80,000**
Current property value:	**£150,000**
Capital growth:	**£70,000 (£150,000-£80,000)**

Once you know the capital growth figure as well as the gross yield, you can start comparing how different properties you own have performed, i.e. which delivers the best yield and which has delivered the best capital growth.

Then you can work out your total returns, which will allow you to more accurately compare buy to let property returns against other investments.

Total Buy to Let Return

This is calculated by adding the capital growth return to the rental income return over the same time period, for example:

Property purchased in 2002 for:	**£125,000**
Valued 10 years later in 2012 at:	**£150,000**
Capital growth is:	**£25,000**
Your annual capital growth return is	**£25,000 ÷ 10 years = 2.5%**

You then need to calculate your rental income (Rental income is the money the tenant pays when you let the property to them) over the 10 years you've owned the property.

Say you've earned £60,000, then your rental income return is £60,000 ÷ 10 years = 6%.

So, your total annual buy to let investment return is 2.5% + 6% = 8.5%.

If you compare this with a savings account that gives you a guaranteed 7% annual return, the buy to let investment looks better. However, you do need to balance the risks of putting the money in a savings account versus investing your money in a buy to let property.

The upside of the savings account is that the return is guaranteed, typically annually or at the end of a fixed term. The downside of the buy to let investment is you will typically need to tie up your money for 15-20 years to secure a good return versus other investments.

Buy to let returns can also vary from one year to the next. For example, rents dropped by up to 20% between 2008 and 2009. Property prices for the first five years after the credit crunch dropped by up to 20% - more in some areas. So, because buy to let returns are not guaranteed, property is considered higher risk than simply putting money in a savings account.

Understanding gross yield and a simple capital growth calculation is just the first part of learning to compare property investments. When working out your objectives or investment returns for tax purposes, you'll need to do more complicated calculations, involving understanding net yield and HMRC's definition of capital growth from a property tax perspective. Work with a specialist wealth or tax advisor to help ensure you get this right from the start.