TIPS The Investment Property Strategists

Finance Structuring and Property Investment Strategies

SELF ANALYSIS and PROPERTY RISK ANALYSIS

Risk Analysis:

This is your reference guide and may be completed as many times as you like to assist in your understanding of what kind of investor you are and your tolerance to risk.

We suggest that this be done annually, as risk tolerance can change with the gaining of knowledge and life experience.

For couples who choose to invest together we recommend that the questionnaire portion of this module be done separately and the answers discussed after completion.

This will ensure that both parties move forward from a mutually acceptable point, therefore being comfortable with their joint investment decisions and choices.

Which Property:

This material has been designed to give you a practical understanding, and appreciation, of the various investment property types available and the different risk profiles inherent to them.

The choice of which type of property you choose will be reliant on your risk profile and a long term view will need to be taken.

WHAT TYPE OF INVESTOR ARE YOU ?

The following questions will help you to identify your risk profile as it applies to property investing. Please choose one answer in each section.

How would you describe yourself?

1. Retired and dependent on existing funds and/or pensions for income.
2. With a family to support. While you understand the need to invest, you cannot see how it will be possible, as your income is fully committed to the family budget
3. Easily managing your current financial commitments. Your current income provides an acceptable lifestyle. You may be just starting out on your career or be well established.
4. At the peak of your career and income, possibly with a dual income. You have no dependants or easily manage the expense needs of your dependants.

What is your understanding of investing in Property?

1. Not very familiar with it.
2. You understand the need to invest but no more
3. You understand how different property types can produce differing income and growth,
4. You are an experienced investor with a current property portfolio.

What are your financial goals?

1. Income from an investment is the most important thing to you.
2. Safety is the most important feature for you.
3. You have a specific timeframe of, say, around five years and a set return you would like to achieve in that time.
4. Growth is the most important thing to you.

If your property were to suddenly lose value by 20%, what would your reaction be?

1. You would sell up immediately and never invest in property again
2. You would keep what you had but not buy anymore
3. You would be concerned but would wait and see for a while before you invested again
4. You would not be concerned – you might even invest more in the same area while you can get a bargain!

Which do you prefer?

1. Stable though low returns.
2. Consistent returns with minimal tax savings.
3. Variable returns with good tax savings.
4. Higher returns with maximum tax savings (but higher risk).

When do you plan to retire?

1. Already retired.
2. Within five years.
3. In 5 to 15 years.
4. In more than 15

How often would you sell your property?

1. Never
2. Within 10 years
3. Every time there is a substantial gain.
4. Every year or two.

In relation to buying property unseen, you feel?

1. You simply could not do it
2. You may be able to do it if you had lots of pictures
3. You would be happy to do so if you had someone you could trust to go and look
4. You don't need to see it at all as long as the figures stack up

Use the Following Formula to add up your score,

For every 1 answer, score one point.
For every 2 answer, score two points.
For every 3 answer, score three points.
For every 4 answer, score four points.

Your Results:

0-8 points: Conservative
Preserving your capital is the most important consideration for you. You have a short-term investment period in which income and capital stability is of prime concern. You should invest in low risk property, which includes standard residential property in well populated city suburbs or large regional towns.
You should ensure a low ‘Loan to valuation ratio” (LVR), say around 50 – 60%.

8–12 points: Stable
Your investment term is three to five years, and you are willing to take a small degree of short-term risk if it means the chance of long-term returns. Security is very important to you though, and income is more important than growth. You should buy standard residential and you may be able to buy in smaller towns with economic vibrancy such as mining towns. You can comfortably set your LVR at 80%

13–21 points: Balanced
You have a relatively long period in which to invest and are comfortable with short-term volatility for long-term growth and income. That is, you would like some security but are prepared to take some risk.
You could invest in standard residential, short tern holiday let with standard management and some commercial premises such as offices with high demand. Your LVR is comfortable at 80%.

22–28 points: Assertive
You look for growth investments and are willing to include some speculative investments. You can cope with negative returns and increased volatility. Capital growth is your prime concern. You can invest in Inner city apartments (may have high growth) or niche market properties such as serviced apartments and retirement villages (high income) as well as factories and warehouses.
You could stand up to a 90% LVR if necessary. High-income earners may stand negative cash flow.

It is recommended that you seek professional advice from an independent, licensed, qualified investment adviser, accountant or legal practitioner prior to implementing any investment program or financial plan.

A DIFFERENT PROPERTY – A DIFFERENT RISK !

There should be little or no emotion involved in buying an investment property. All houses are “bricks and sticks”, not “homes” – at least not until you try to rent them out.
Human emotion is what selling agents manipulate to squeeze a few thousand dollars more out of you or coerce you to speed up the settlement process/time.

The first thing you need to appreciate is that you are buying property for other people [not you] to live in. So long as the properties are “safe and comfortable”, who cares if there is a modern stove or what colour the walls are?

Often, investors will use their own standards as a benchmark for determining a “good house”. Indeed, it may feel good to only buy quality properties that you would be proud calling your own home.
But, common sense dictates that you will have higher standards for your own “home” than other people will have, living in a “rented” property.
This translates into paying too much for investments because you've brought unnecessary emotion into the deal.

Most opinions you'll hear are really statements of emotion. Let the facts speak with more authority than the opinions.

The fundamental benefit of property investing is the passive income it can generate.

A cash flow positive [or positively geared] property [one that provides you more money than you spend on maintaining it] makes you money from day one.
Any capital gain you make on top of the passive income is a bonus.

Successful property investors usually seek long-term income streams rather than sudden [short-term] capital gains.

There are many types of “property” to choose from when considering real estate as an investment.

There are houses, apartments, factories (commercial), holiday homes, retirement villages, managed apartments, student accommodation - even car spaces.
Is one a better choice than another? Well, that depends on the market, so let’s examine this concept.

Unless you have experience in a particular area, keep your investment decision as simple as possible. Look to buy a house in an average area where the average person would live.
There will always be demand for a "normal" house where the average person or family would like to live.

You could buy high priced property and cater for the "top end of town", but you then run the risk of higher vacancies and only having short-term tenants.
More expensive houses also require more maintenance to retain the top rents charged, in addition to higher deposits to purchase it in the first place.

Higher risk usually equates to higher returns and you can look at retirement villages, managed apartments, student accommodation and commercial properties as being in this category, but realise that these operate in a more volatile market.

The higher the volatility in your market, the higher your investment risks!

Property can be a solid investment opportunity since, as population increases, so to does the demand for accommodation.
So-called average houses, where a "normal" family would live, are good prospective investment properties, as demand will always exist and long-term vacancies are unlikely.
The shift in demand usually starts with average type houses, which then adds to the likelihood of capital gains over the term of your investment.
Property is also a basic human need. When the going gets tough people can live without cars and take-away… but not without a roof over their heads!

A so-called “average” property is a good starting point for potential real estate investments.

Choices…House or Unit:

House price growth (7.4% per annum) over the last decade has outstripped unit price growth (5.3% per annum) over the same time period (although a changing trend is beginning to appear from recent figures)

The obvious question is why this should be so? And the reasonably obvious answer is land!

Land is a finite resource and, as the population continues to increase, the demand for housing increases and, with the supply of land unable to be increased, land prices [and, consequently the price of house and land packages] increase.

Units occupy much less land. Units don't spread out consuming land. They spread up, consuming air.
So while the demand for units may be increasing with the increased population, the supply of units also has much greater capacity to increase.
As a result of this, prices of units tend to increase more slowly than those of houses.
Given the speed with which many large unit developments are being completed, are there now more units available than the investors' market can absorb…equally importantly, are there more units available than the renters' market can absorb?

Anecdotal evidence would tell us that most of the new large unit developments in the CBD and other areas are being sold without excessive amounts of difficulty.

In this sense, there seems to be little evidence of oversupply.

However, most observers of these blocks would note that there also seems to be higher than usual vacancy rates in these buildings. That is, while the units are selling without excessive difficulty, they seem to be proving more difficult to rent.
An examination of rental yields over the past decade shows that while unit rental yields have generally been in excess of those of houses, both have been decreasing since late 1996 and have more or less reached parity…units are still slightly higher, but only marginally.

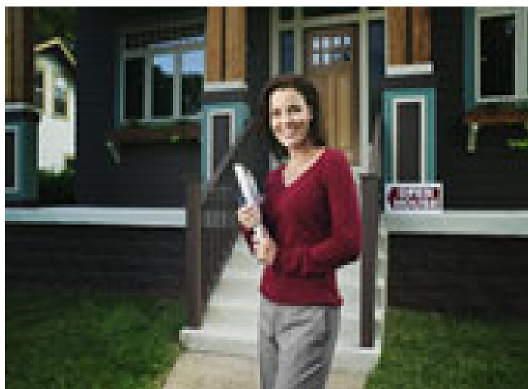
However, the consequence to the investor of this relative fall in rent rates is that the rental income is less able to meet the necessary interest repayments.
While there are some tax advantages to this, and many investors use their investment properties to receive these tax benefits, this strategy is only effective if one can make a good capital growth profit when the property is eventually sold.

Such a profit has proved relatively easy to obtain in the past and should remain so over the long-term future, even for the slower growing unit sector however, you do not want to be in a position where economic hard times require a property to be sold due to an inability to meet repayments.

The greater the differential between rent rates and interest rates, the more difficult it is to meet repayment obligations when times are tough, and in a market that suffers high vacancy rates, the risk is increased even further.

So, are we suggesting that investing in units is a bad idea? Not necessarily!

A well positioned unit investment does present many advantages and often provides very attractive returns.
Its lower cost is also welcome for those who want to get into the housing market and have limited funds however; greater care needs to be taken with a unit investment than a house and land investment with the avoidance of the upper ends of the market, as it is more difficult to find renters in these markets.



People with incomes sufficient to afford the rent often (but not always) choose to buy instead.
This will decrease your market. Remember too, that “upper end of the market” is a relative term.
A rental amount that is reasonable for a two or three bedroom unit may be high, and difficult to obtain, for a one bedroom unit.

There is one other factor to consider with units that needs to be discussed.
Each unit block that is strata titled has a body corporate and charges levies to

provide for repairs and maintenance with some of the very large unit developments having more than one hundred different unit owners.

More owners mean a greater diversity of ideas and desires.

The larger we allow the unit block the larger the potential problems.
Often owners will vote down levies to low levels simply because the majority can't afford increases to renovate the building.

As a unit investor, this factor needs to be considered.

You don't have complete control over the future quality of your investment therefore you don't have complete control over the level of capital growth that you may ultimately achieve.
(Of course, you don't have complete control of capital growth in any market you care to invest in, but units have this extra risk).

Again, we are not suggesting that investors avoid units, but there are very clear risks involved in a unit investment and it is much better to be aware of those risks *before* making the investment rather than after making it.

Try to invest in an area that is going to show as high a level of capital growth as possible.

Invest in a block that is well-positioned, desirable and well-maintained and invest in a unit that is affordable (often a second-hand unit investment is a far better investment than a new unit) and easier to rent out to a variety of people.

Units have often been thought of as housing for the young because they are usually cheaper, lower maintenance and frequently provide close city living.

It is becoming apparent that unit dwellings are attractive to the “young at heart” demographic with many retirees move into unit living.

The most obvious reason is that units are usually more affordable, making them an ideal investment for individuals establishing themselves.

This characteristic also makes them attractive to the older demographic as retirees can free up equity by selling their more expensive family home to live in a less expensive unit, so they are cashed-up for retirement.

The comparatively low maintenance of units is also a draw card as there is usually no garden to look after and any maintenance that is required is managed by the Body Corporate.

This can make units advantageous for both owner occupiers and investors.

From an investor's perspective, units provide a number of advantages:

- Investors frequently achieve higher rental returns, because the proportion of rent to the amount invested in buying the property is higher.

- Body Corporate fees and other associated maintenance costs allow the investor to reduce their taxable income.

The primary reason for investing in houses over units is that houses have a greater potential for growth due to the greater land content attached to houses.
This occurs because land follows the principle of supply and demand and since developable land is in short supply, good growth may be expected.

With apartments and units a larger capacity still exists to build more as low density homes can be knocked down and replaced with large unit blocks.

The land content attached to homes also results in this dwelling type being less risky and therefore better suited to the conservative or stable investor.

A greater capacity also exists to increase the home's value.

With units there is only so much renovating you can do…you can update the kitchen or bathroom, replace the carpet or paint the walls.

With houses however, renovations can be far more extensive as you may be able to add an extra bedroom or landscape the garden thereby significantly increasing your property's value.

With a free standing home you are also not paying Body Corporate fees to maintain communal areas.

This is particularly the case in newer unit blocks or "Managed" complexes, where maintenance of the "life style" facilities such as the GYM or pool may be costly and management agreements potentially become unfavourable to the investor with reduced returns from higher fees and charges from renewed agreements.

Choices… Managed Apartment, Retirement Village or Commercial:

Serviced/Managed Apartments and Retirement Villages are considered riskier due to their limited security. Income streams can be variable and costs can be significant.

While the figures may stack up during the research stage the ongoing success is dependent upon the quality of the management structure and as management rights can be bought and sold on the open market the management of your asset can be inconsistent.

The critical issue is the inconsistency of income as usually there are peaks and troughs.
In some instances income and costs are shared equally and yet in other instances the room only earns income if it has a resident.

They are a niche property and only attract niche investors.

Banks are hesitant to finance these properties due to the risky nature of them.
The reason why Lenders do not like this type of property is that there is a limited market in the event the Lender had to repossess the property, as generally, owner occupiers are unable to buy the property to live in and there is a limited market when it comes to investors.

They are what the Lenders call unacceptable security and some Lenders will only lend 50% to 65% of the purchase price.

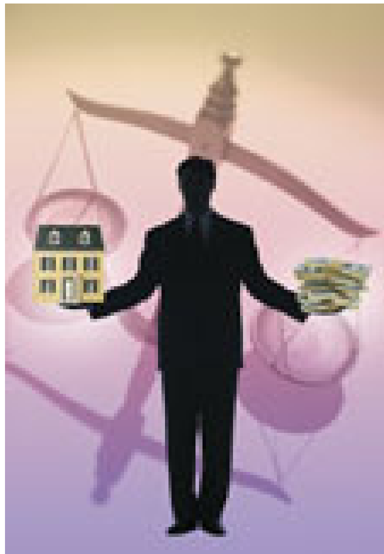
You may also find the purchase price contains a furniture pack (assumed worth of $25,000).
When a valuer goes out to do the valuation he will take the cost of the furniture pack off the purchase price and then do the valuation on that figure.

Therefore, if you were to purchase a serviced apartment for $300,000 and there was a $25,000 furniture pack the valuer would do a valuation on a $275,000 purchase price.

If the valuer was to do the valuation at $275,000, the purchaser would have to come up with $25,000 for the furniture pack, plus anything from 35%-50% deposit on the property… if they could find a lender that would accept serviced apartments as security.

When venturing into commercial, you still have to do your research to select the property, determine demand, rents and growth potential.

Commercial investment is a different game with different rules.



Contracts are complex and lease details are critical to an investment's success.
You will need to be aware of goods and services taxes, as GST will impact on purchases, on rents, levies and all services.

Vacant property sales attract GST and one way to minimise GST on purchases is to buy a going business.

If you buy a vacant property GST can be on the purchase price, or on the margin (That is tax on the difference between the value of the property immediately pre-GST and its current value).

Margin valuations can be open to dispute.

Opting for GST on the purchase price is simpler, making it easier for buyers to get it back in tax returns when calculations are more readily understood.

But it is the documentation that needs precise attention.

When purchasing you will usually get an agent's feasibility study, contract, lease extracts, a selling history of the property and sometimes strata management accounts if it is a strata property.

What these tell you is whether you should take the next steps and start investing more time and money.

You will need a Conveyancing Agent or Solicitor, and sometimes a valuer, accountant, building/pest inspector and someone qualified to give you a depreciation schedule on fittings and fixtures for tax claims.

Some of the advantages of investing in commercial property are that rents are quoted annually; tenants have a strong interest in property maintenance as it reflects on their business; and leases tend to be long with management overheads usually a lower percentage of the purchase price.
When buying a commercial property check to clearly establish tenant rights and obligations and those of landlords.
These may include:

- Lease expiry and option times (This is because you are buying for income stream from a secure tenant. Lease values are built into prices, forming part of yield and value projections).

- The lease times let each party know the other's intentions.

- Tenants usually pay rent and GST, council/water rates, strata levies, repair and maintenance [but not capital works] and sometimes land tax. Anything additional can be attached to leases and agreed.

- Default clauses for rent arrears.

- Due diligence on tenants (Credit associations can be used).

Commercial residential premises:

By definition, a commercial residential premise includes hotels, motels, inns and hostels, boarding houses and caravan parks.

Special rules apply where commercial residential premises are used for long-term accommodation e.g. accommodation that is rented for a continuous period of 28 days or more.

Where residential premises are commercial residential premises, the sale is fully taxable.

This means that upon sale the vendor is required to remit 1/11th of the total sale price to the ATO. Of course the purchaser, if a registered business, is able to claim 1/11th of the price upon purchase as an input tax credit from the ATO.

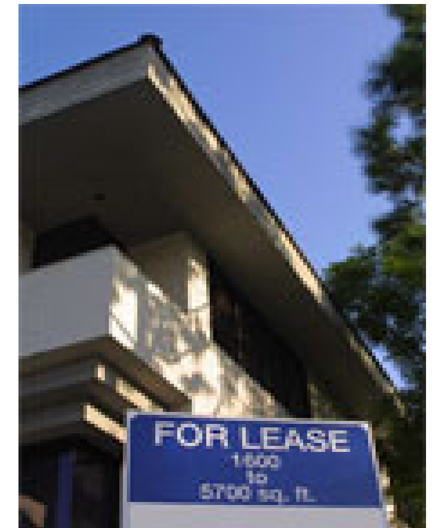
Commercial property rentals:

Lease payments made under a commercial lease are subject to GST.
A commercial lease on commercial residential premises and commercial accommodation is subject to special rules.

Requirements for separate treatment:

In the case of long-term accommodation, if the accommodation was classified as input taxed (such as the supply of residential rent), the supplier of the accommodation would have to apportion input tax credits between that part that relates to the residential accommodation and that part that relates to services.

In order to avoid this and to simplify the potential complexity of the apportionment calculation that would be required, a concessionary treatment for long-term accommodation is provided for by the legislation.



Concession:

Long-term stays in commercial residential premises are given a lower value than would otherwise apply, reducing the amount of GST payable.

The concession applies where you supply accommodation to an individual for more than 27 days and your premises are predominantly for long-term accommodation.

The value of the supply of commercial accommodation is 50% of the price from the start of the stay.

You provide commercial residential premises predominantly for long term accommodation where at least 70% of the individuals who you provide with the commercial accommodation are staying for a period of 28 days or more.

Commercial accommodation is defined as the right to occupy the premises and as part of the right, any of the following are provided:

-Cleaning and maintenance.

-Electricity, gas, air-conditioning or heating and

-Telephone, television, radio or any other similar item.

Premises not predominantly for long term accommodation:

If you supply accommodation to an individual and your premises are not predominantly for long term accommodation, GST is payable for the full value of the supply for the first 27 days.

For the remainder of the stay, the value of the supply of commercial accommodation is 50% of the price.

Retail and commercial leases:

The lease rental payment on a retail and commercial lease is subject to GST at the rate of 10%.

Provided the lessor is a registered entity, any GST paid in relation to providing the supply of the retail premises can be recovered by the lessor, if the lessor claims input tax credits.

Partial Purposes:

Situations where this scenario needs some consideration are likely to arise where taxpayers conduct part or all of their business in a separate section of the home that they also reside in.

Some primary examples of where this may occur are medical practices, shop fronts and the provision of music lessons from a designated music room.

In such instances, it is necessary to apportion the taxable and input taxed components of the lease to determine what the input tax credit entitlement of the lessor is likely to be.

Special rules:

The Margin Scheme:

If you are a registered entity, you have the choice of calculating GST on the supply of freehold interests in land, of stratum units and long term leases, on the margin of that supply (which is the value added by your business) or under the usual rules.

The margin is calculated as the tax inclusive sale price (when the property is eventually sold) less your original purchase price or if you held the property at 1 July 2000, the value of the property at 1 July 2000. This ensures that GST is only payable on the value added after the commencement of the GST system.

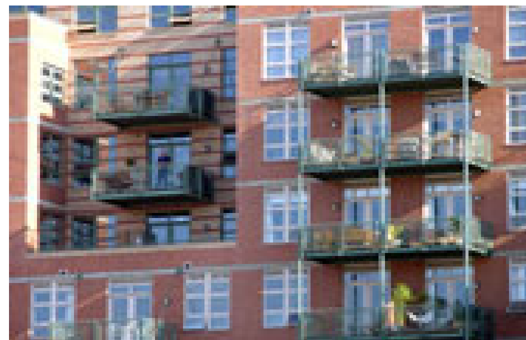
What next:

In summary, houses are generally less risky and provide better capital returns. As a home owner you have greater freedom to develop your property the way you want without approval from other tenants.
However buying a house in most cases is considerably more expensive and therefore may not always be an option.

If you do decide to invest in a unit you can reduce the risks and get good returns by researching and selecting a dwelling that has unique desirable attributes in locations that currently and in the future, are unlikely to undergo significant unit development.

Successful real estate investing takes time to learn, understand and then put into practice, but always remember, you should look to try to make a return from day one.

Look for positively geared cash-flow property that shows potential to also appreciate in value over an investment time frame of ten or more years.



You don't have to love it as a dream home, it's an investment property!
Property Investors are not just in the business of property they are in the business of making money.

It is recommended that you seek professional advice from an independent, licensed, qualified investment adviser, accountant or legal practitioner prior to implementing any investment program or financial plan.

Notes: