10 ways to manage 'negative equity'

Like shares, property has its booms and busts. So what do you do when there's a downturn and your property falls in value? How do you manage the situation? Do you sell, hold or do something else? *Helen Collier-Kogtevs*, director of Real Wealth Australia, investigates

While at a property expo in Sydney recently, I took the time to ask investors their opinion on the health of the Sydney property market, and the impact the market was having on them.

It was clear that sentiment was more negative than positive. Most said they were experiencing a negative impact in some form, and some even went so far as to say they were experiencing a 'negative equity' situation and were considering selling their properties.

I think everyone now realises that we're well and truly in the middle of an economic downturn, in both local and world financial markets and, as a result, investors are starting to feel the hurt as interest rate increases and falling house prices start to bite into their hard-earned equity.

This sentiment isn't uncommon. Each day I receive phone calls from distressed investors who have heavily geared their property portfolios and who are now struggling to keep a firm foothold under the weight of rising rates and falling house prices.

The fear factor

Instead of buying more property, investors are now starting to pull back and consolidate their assets in an effort to weather the situation. The withdrawal of buyers in some areas is also adding to the downward pressure on property prices, and vendors are becoming even more distressed. For some newly purchased property that hasn't yet experienced significant capital growth, the downward price spiral has resulted in the current price being less than the purchase price.

If this situation isn't addressed, it could create serious problems for investors. The dilemma they face is, should they hold or should they sell? If they sell at a price that's less than the original purchase price, a negative equity situation will result, and they'll have to fund the deficit when the property sells. This means they'll have lost money on the deal – and no investor wants that. If they decide not to sell and instead hold on to the property, they might end up in even deeper trouble – or will they?

According to the Australian Bureau of Statistics, Sydney has posted the sharpest decline in housing prices across the nation, with average prices falling 1.5% in the March 2008 quarter, with Perth not far behind. Most of the 'help! calls to me have been from investors who own properties in these two capital cities.

Sydney has been experiencing a downturn for quite some time now. I can report that my Sydney properties have all been experiencing little or no growth over the last couple of years. Luckily for me, I purchased these properties well before the peak of the last boom and have therefore not had to endure the dilemma of dealing with a negative equity situation.

How real is negative equity?

The reality and likelihood that some properties will experience negative equity is a very real proposition in today's less than rosy economic climate. It's more likely to be experienced by investors who have purchased highly negatively geared properties at the peak of the last boom. That is, they've purchased property in a hot, overpriced market.

Many of these investors will be getting anxious, because increases in rental returns haven't been enough to cover the increases in mortgage interest rates. Some investors want to sell, but if they do so, they may be left with unexpected debt caused by their negative equity situation, and they'll have no equity or rental income from the property to be able to support the increased level of debt.

Taking control of negative equity

The following 10 actions will help you manage a negative equity situation.

1 Understand the problem

If you believe you're in a negative equity situation, then before you do anything make sure you get a full and complete understanding of the problem you're facing.

This will require a high degree of due diligence in order to validate the information that's being fed to you by the media and other sources.

After this has been completed, you'll need to identify the impact that the negative equity situation is likely to have on you and your properties, and then work out what you'll need to do to tackle this situation.

There's been a whole lot of negative media lately about the downturn in the economy, so you'll need to be able to sort the chaff from the wheat if you want to successfully see your way through it.

Some media reports have claimed that the price of property will drop by up to 30% or more during the course of this current downturn. This may be the case in some poorly selected investment areas; however, investors who have purchased good, solid investments in quality areas will more than likely never have to experience this level of pain.

The problem with media hype is that investors who act on it sometimes make the wrong decisions and regret them later.

So why do investors sell? The reason usually stems from being fearful and caught up in hype.

The problem is that when investors make a drastic decision to sell before fully considering their position – and what they can or can't do about it – it usually results in mistakes being made. Most new investors won't have experienced the full force and pain of a downturn, and will therefore panic over adverse media hype.

It's important to understand that like boom times, downturns don't last forever. Investors who have owned property for less than three years, and are considering selling up and leaving the market, should seriously reconsider their position, as they'll more than likely lose money if they do.

2 Don't sell

History tells us that downturns last between 18 months and two years, so if you have a well-performing property and can afford to hang on to it, then don't sell. It will cost you as much to sell it as it will cost you in additional interest payments payable during the course of the downturn.

Many investors are selling out of fear rather than logic, and they're prepared to take a hit for the sake of getting rid of the headache. For me, it just doesn't make sense to sell something for less than I purchased it for, when I know that history has a habit of repeating itself, so the price will more than likely rebound after the downturn.

While I have the tenant and the tax man helping me pay for it, I'd rather hold on to the property for the long term. I understand that cash flow is the issue, but rather than work harder, why not work smarter?

I believe that most investors who get caught up in a negative equity situation can, if they consider their position properly, be in a position to work through their financial issues without having to sell the property. It's just a case of working out how to do it.

My recommendation is, where possible, ride the peaks and troughs of the market and don't sell. If you have a solid investment strategy that's backed up by solid investment properties, you'll profit in almost any market.

Right now, with the downturn in full swing, it's a buyer's market, so all investors should be looking to buy, not sell. You shouldn't be paying full price for a property in a distressed market. This is the time for savvy investors to be able to create equity going into the deal. How great is that?

When it comes to property, location, time, cash flow and capital appreciation are the catalysts for creating real wealth.

3 Increase rents

The common complaint of investors who are negatively geared is lack of cash flow. My suggestion is to increase rent. There are a lot of tenants out there who are paying

> Investors who have owned property for less than three years, and are considering selling up and leaving the market, should seriously reconsider their position as they'll more than likely lose money if they do

below-market rent for their leased properties, and sympathetic investors aren't putting up the rent of their investment properties because the tenant is a good, long-term resident who has looked after the place.

It's all well and good to give a tenant a discount, but some investors that I've recently spoken to are creating negative equity situations for themselves by allowing their tenants to pay below-market rents. Crazy stuff.

> If you have a solid investment strategy that's backed up by solid investment properties, you'll profit in almost any market

One example of this is when I recently had an investor tell me he was struggling to pay his mortgage on his Sydney investment property. I discovered that he was charging rent of only $800 per month for a three-bedroom house. This property could easily fetch $1,500 per month if it were pitched at the true market value. How much better off do you think the investor would be with a rental increase like that?

The above example is common among investors. The message doesn't seem to be getting through to some.

Many see negative gearing as the only way to invest but, often, negative gearing only keeps you in your day job for longer. Investing in property is all about creating wealth so we have more time to do the things we want, yet investors seem to be fixed on working harder to fund their shortfall in their investment property mortgages.

If you want to stay ahead of the negative equity game, it's imperative that all investors review the rents on their investment properties annually. We're experiencing a severe rental shortage, so again, it's an opportunity for all investors to increase their rental returns, improve their cash flow and stave off a negative equity situation.

4 Increase the available equity in your properties

For those investment properties that have increased in value over the last six months, investors can draw out the additional equity by getting the properties revalued. The additional equity should then be put into an offset account that's linked to the loan. The equity can be used to support any negatively geared properties during the downturn in the market.

The trick here is to get the bank valuer to value the property at true market value, rather than 5–10% below market value, which is what often happens. The way to do this is to help the bank valuer with their valuation by providing them with up-to-date data that supports the true market value of the property.

I can't begin to tell you what a difference having a licensed property valuer on my panel of experts has made. My valuer Olivia has been fantastic to have around. Like me, she calls a spade a spade, and in the game of investing, having someone who'll tell it to you straight can make all the difference.

Olivia has helped me in managing other valuers when it comes to revaluing my properties in other states. I no longer accept drive-by or curbside valuations from a bank valuer. I no longer accept the valuation they provide if I feel they're being too conservative. I insist they go through the property and see it with their own eyes. Believe it or not, this can help in preventing the property being valued below market value.

While it's important to get proper valuation advice, you still have to do your homework and know what the valuer needs to know to make their valuation. No one will ever protect your wealth better than you!

As part of your due diligence, you need to research your property and its value. How? I begin by asking local agents to give me an appraisal of the property in which they also provide me with comparable sales, historic data, trends and median prices. Your local agents can be the difference in helping you achieve growth in your property as opposed to leaving it up to the valuer to guestimate your property's value. The valuer will always take the easier road, and as many investors don't realise they can contest a valuation, often valuers get away with giving low valuations.

You can make a valuation work in your favour by:

- Knowing as much about the area as the valuer does
- Doing the valuer's work for them

When you think about it, a bank valuer gets paid somewhere between $200–300 per completed valuation. To earn this, they should have driven to your property, inspected it, taken notes, gone back to their office and called local agents and/or reviewed relevant recent sales data in the area.

They then need to type up a valuation report on the property and send it to the bank. Many banks put time limits on valuers, which mean they must turn the valuation around in 24–48 hours of receiving the request. A valuer will perform up to eight valuations a day, hence curbside valuations help speed up the process.

I like to make their life easier by doing the work for them. I gather as much sales data as I can of comparable sales in the area. When speaking to the valuer, I also ensure that he or she knows I'm an investor and have a high level of local knowledge. I also provide my thoughts on what the valuation should be – a ball park figure. My homework supports my analysis.

When I follow this approach, nine times out of 10, I receive the valuation I was expecting. This is because I've spent a little time doing the research and looking at data. It's not rocket science, it doesn't take much time and it helps protect my investment from a negative equity situation.

> My preference is to always use interest-only loans that allow for extra repayments so I can make additional repayments when it suits me

5 Add value in times of equity threat

Sometimes throwing good money after bad isn't the best option. Renovations are one way of adding value, but I caution you to look closely at your figures to ensure that you aren't over-capitalising and making the problem worse.

If you have spare cash, I'd recommend putting it in an offset account to help reduce repayments, and wait until the market picks up before spending the dough to add value through renovation. Some may disagree, but I'd rather play it safe than be sorry.

Adding value through developing, strata titling or subdividing are other ways of increasing the value of a property. The strategy here is that it usually takes time to receive council approval – sometimes up to two years. For a development, it means that you could potentially go through the motion of commissioning an architect to design the development and lodge an application to council. This process can take months, or possibly years, depending on the local council.

It could mean that you're adding value through development approval (DA) without going to the expense of building the development. The thinking behind this is hopefully the market will have turned by the time your DA application is approved. You then have an additional two years to build the development before your approval expires – which, again, buys you more time before you have to undertake expensive construction.

It's worth thinking about; but on the negative side, developing is a whole new ball game and has its own level of risk. It's important to understand, as best you can, what the best- and worst-case scenarios for proceeding with your development are.

If you then had to sell the property because your negative equity situation deteriorated, the market value is likely to be higher because of the value-adding approach.

6 Only buy positive cash-flow properties

If you have a negative equity situation and you're compelled to buy another property, look at purchasing only positive cash-flow properties to help fund the negative cash flow of the negatively geared properties. Yes, positive cash-flow properties do exist – they're everywhere – you just need to look harder.

7 Increase cash flow through a P1515

If you're employed on a PAYE basis, you can receive payment of your deductible investment property expenses at each PAYE pay period by asking your accountant to help you fill out and lodge an Australian Taxation Office (ATO) P1515 application form.

The property expenses will be paid to you as a reduction in the amount of tax that's payable at each pay period. In effect, you receive your tax return in your pay packet each pay day, instead of waiting until the end of the financial year. This can help with cash flow if you're in a negative equity situation.

8 Prepay your annual mortgage interest repayments

The ATO provides you with the option of prepaying the mortgage interest repayments in advance for the next year, and then claiming the prepaid interest in the current tax year. This can effectively reduce your taxable income and hence minimise the amount of tax payable.

This strategy works if you have spare cash to prepay the mortgage interest payments in advance, giving you some breathing space during a negative equity situation.

I personally am not a big fan of this strategy because it does eventually catch up with you the following year, but I understand that it can be very helpful for investors in the short term.

9 Opt for interest-only loan repayments

Home loans that are issued for owner-occupied residences are usually principal & interest (P&I) home loans. Most lenders, however, also offer interest-only (IO) loans.

The difference is that with a P&I loan you pay more in mortgage payments than someone who has an IO loan. The reason is that the P&I mortgage payment includes a small payment towards the principal amount borrowed, so that after the full term of the loan, you'll have paid back the full amount of the principal.

Most investors opt for IO loans because the amount of the principal paid each month isn't tax deductible, whereas the interest component is. With an IO loan, the principal will never be paid off.

If you convert from a P&I loan to an IO loan, it will enable you to reduce your monthly mortgage repayment amount, which in turn will help to combat the interest rate increases, without you having to find the extra cash from somewhere else.

Take, for example, a $500,000 loan with a 30-year term and an interest rate of 9.46%. The P&I monthly repayment would be $4,189.69, whereas an IO monthly repayment would be $3,941.67. This equates to a saving of $248.

You should also check to see if the lender will allow you to switch back to P&I repayments at any time without penalty.

My preference is to always use IO loans that allow for extra repayments. This way, I receive the benefit of increased cash flow by having IO terms, but have the flexibility of making additional repayments when it suits me.

10 Change from low-doc to full-doc

Quite often, self-employed or small business owners use low-doc or no-doc loans when purchasing property. This is usually because they're unable to provide the lender with full documentation of financials. The interest rate for these loans can be slightly higher, although there are some lenders who offer really good rates for the self-employed.

If you fit into this category and have an existing loan, you may be able to go back to your lender and provide them with full financials – hence you may be eligible for a reduction in your interest rate, because you've provided updated financial information. You'll need to check with your lender, as there may be some conditions that need to be met to qualify for the rate reduction.

The rules of the property game

Playing the game of investing requires you to follow a few simple rules:

- Never sell in a downturn unless you absolutely have to
- Use strategies to increase your cash flow to help you survive the tough times and any negative equity situation that you might be experiencing
- Continually review your rents and do your homework when it comes to valuations
- If you hold on and make sure you're spot on with your mortgage repayments, there should be no reason for a bank or lender to call you on a negative equity situation that you may be in
- In a downturn, just keep things 'steady as she goes' and this will help with avoiding negative equity and the nightmare of having the banks on your back

My golden rule in property is to never sell. However, in saying that, I do have strict rules around the returns I receive from each property. I had a couple of properties that were performing well, but not to the level I wanted, so I sold them.

Regardless of what's happening in the marketplace, your golden rule should be to have peace of mind. There's no point worrying yourself to death over a property or compromising your relationships over money.

Remember, the key to real wealth is love, relationships and family. Money just gives you choices – it isn't designed to be accumulated at the expense of your peace of mind.

Until next time, happy investing.

Helen Collier-Kogtevs is an investor and the author of '47 biggest mistakes made by property investors and how to avoid them'