

Game on

In the property investment game, a carefully considered plan is crucial. In the first of a regular feature, we ask a property expert to devise an investment strategy for one aspiring investor.

So you have the money, you have the desire, but you don't have a clue where to start. Meet Julia Markwell and Chris Hempenstall, a couple based in Melbourne, Victoria.

As tenants in the city's tight rental market, Julia and Chris know their weekly rental payments could be better spent paying off an investment property of their own. Currently living in the inner suburb of South Yarra, the couple pays around \$24,000 a year in rent – hard-earned money that flows straight from their pockets into their landlord's.

As their careers have progressed, so too have their salaries, which now stand at a combined \$200,000 pa before tax. David Wegener of Club Financial crunched their borrowing capacity up to \$1.3m after taking into account annual expenses of approximately \$91,812, their disposable annual income of around \$64,188 and their combined savings of \$45,000. David also took into account 80% of the rental income and 100% of deductible interest in the calculation.

But like many young professionals aged in their 20s, Julia and Chris aren't

ready to give up their lifestyles just yet. Dining out still plays a large role in the budget, and the couple has plans to embark on a six-month adventure around the globe next year.

The high income earners' spending habits have matured over the years and impulsive spending has now been cast aside for a closer look at investment. Property has piqued their interest because of its ability to generate equity for future purchases. Yet like many others in their position, taking that first step into the market is the most terrifying. It's a mental barrier that brings an entourage of questions.

Is it possible to maintain a lifestyle while paying off a mortgage? How much will an investment property really cost? How can you take advantage of concessions come tax time? What's the best way to structure one's finances?

Property expert Helen Collier-Kogtevs crunched the numbers to devise an investment strategy for these first-time investors.

Players stats: Julia Markwell and Chris Hempenstall



Ages: 26 and 28

Occupations:
Chemical engineers

Combined salaries pre-tax:
\$200,000 pa

Combined salaries after tax:
\$156,000 pa

Estimated combined expenses:
\$91,812 pa

Combined savings:
\$45,000

Investments:
\$50,000 in shares

MONTHLY BUDGET	INCOME	EXPENSE
Salary (after tax)	\$13,000	
Rent		\$2,000
Car loan		\$800
Living (food, clothes, utilities)		\$1,810
Car/transport		\$926
Insurance (car, home, health)		\$495
Leisure/entertainment		\$1,620
Total monthly expenses		\$7,651
Total monthly income	\$13,000	
Monthly disposable income		\$5,349

The gameplan

The fundamentals

What: Purchase a first investment property

When: By 31 March 2011

Where: South Yarra, inner-city Melbourne, Victoria

Why: To generate equity for future investment purchases

How: \$400,000 property (\$40,000 deposit + \$360,000 loan)

Plan: Buy and hold strategy focused on capital growth

The coach: Helen Collier-Kogtevs



As director of Real Wealth Australia, Helen Collier-Kogtevs is a property investment mentor and educator with a passion for tailoring investment strategies to the needs and goals of the individual. She is the author of a number of investment books, including *How to Start*

Creating Real Wealth through Real Estate.

Helen herself is living proof that you can turn your finances around through property investment. It took Helen and her husband Ed just seven years to transform their personal debt into a multi-million-dollar property portfolio. At the age of 39, Helen was able to retire from the daily grind of working for others and established her Victorian-based advisory service.

The goal

The short-term goal is to purchase one investment property that will appreciate in value with rental income largely covering the mortgage repayments. The mortgage size is not to disrupt overseas travel plans and the property must be purchased by 31 March 2011.

As this first property's equity grows, the couple would consider adding to their portfolio with the long-term goal of being financially comfortable and generating a second stream of income through property.

The strategy

For Julia and Chris, it's clear that a capital growth strategy is the best way forward as they're on a high income with high borrowing power. They have a fabulous surplus and the property will in time grow in value, giving them the opportunity to access the equity for future property purchases.

By following a buy and hold strategy, the couple will be able to travel overseas without interference and draw on equity to fund future purchases. They should hold this first property for approximately seven to 10 years. Their high combined income will benefit from negative gearing, which will allow them to claim back a portion of the large amount of tax they currently pay. The property should ideally be new as this will offer the couple the highest level of depreciation.

Risk management

Julia and Chris should limit their risk by eventually diversifying their portfolio across the various sub-markets of Australia, essentially buying predominantly in capital cities across the different states and territories. This will allow them to enjoy ongoing capital growth as the various markets experience peaks and troughs. A conservative financial buffer of \$10,000 has been

allocated to cover any unexpected costs in the first year of property ownership. With expectations of a \$10,000 salary bonus in March 2011, and annual tax returns of a few thousand thereafter, this should cover ongoing buffers into the future. The couple also holds \$50,000 in shares, which could be used as a Plan B buffer, should the need arise.

The prospective investors should ask their lender for a high loan-to-value ratio (LVR) loan of 90%, because their high incomes will dampen the related risk.

Ownership structure

Julia and Chris should hold the property in their own names to maximise tax benefits.

Taking advantage of tax

As the couple currently pays a very high rate of income tax, they can effectively reduce their bill by taking advantage of negative gearing concessions. They should negatively gear the property by approximately \$200 a week, which could then be deducted from their taxable incomes at the end of the financial year. With a current weekly budget surplus of \$1,234, the suggested weekly shortfall of around \$200 will not adversely impact their lifestyle.

The couple should also look at purchasing a new residential property so they can maximise tax deductions by taking advantage of building and chattel depreciation allowances. Investors can write property and chattel depreciation off as a tax-deductible expense with depreciation rates varying in line with the ATO's allowances and the property's construction date. If construction began between 18 July 1985 and 15 September 1987, depreciation is calculated at 4% pa, whereas the rate changes to 2.5% pa if work began after 16 September 1987.

Finance



The numbers

The couple's borrowing power is very high, being calculated at \$1,354,000 without rental income, and \$1,456,000 assuming weekly rent of \$300 from the new property. However, in order to minimise interference with travel plans, they should consider buying something valued between \$300,000 and \$400,000 as their first property.

Assuming a purchase price of \$400,000, the couple's \$45,000 savings would be funnelled into a \$40,000 deposit and \$5,000 initial property acquisition costs (eg, solicitor's fees). The \$6,054 lenders mortgage insurance (LMI) can also be borrowed against the mortgage, increasing the loan amount to \$366,054 and the LVR to 91.5%.

Julia and Chris can look at purchasing an investment property off-the-plan to take advantage of Victorian

state government stamp duty concessions and stretch their savings further. When evaluating loan products, they should look for one with offset account and redraw capabilities, to allow them to reduce their interest payments and to increase their borrowing flexibility when they buy more properties further down the track.

The loan product should also offer minimal loan establishment fees.

BORROWING POWER	\$1,354,000
Purchase price	\$400,000
Deposit	\$40,000
Loan-to-value ratio (LVR)	90%
Loan amount (excl LMI)	\$360,000
Lenders mortgage insurance (LMI)	\$6,054
Stamp duty	\$3,000
Body corporate fee	\$3,000
Financial buffer (salary bonus)	\$10,000
Plan B buffer (shares)	\$50,000
Initial property acquisition costs	\$5,000



Working example of annual income vs expenses

Julia and Chris should aim for an investment property with a rental yield of approximately 4.5% or weekly rental income of \$350 or more. This would amount to an annual rental income of \$18,200. Subtracting this from the estimated property expenses of \$31,682 pa would leave them out of pocket (pre-tax) by \$13,482 pa or \$259 per week.

Depreciation benefits would also come into play. Washington Brown's tax depreciation calculator estimates that a \$400,000 unit built in Melbourne this year would depreciate by roughly \$12,000 in its first year.

The total tax deductions from this investment would lead to an annual tax return from the property of \$7,644 (0.30 X \$25,428), assuming a personal tax rate of 30%.

What and where to buy

The couple's preference for buying in the inner-city Melbourne suburb of South Yarra is a good idea because it fits their buying profile and has strong capital growth, a high rental population and low vacancy rates.

The couple should consider purchasing their second and subsequent properties in other suburbs and/or different states of Australia in order to spread their risk.

A maximum purchase price of \$400,000 will most likely be sufficient to buy a one-bedroom apartment in this inner-city market.

The investors' buying rules

- New property to reduce ongoing maintenance and increase depreciation benefits

- Preferably buy off-the-plan to save on stamp duty
 - Maximum purchase price of \$400,000
 - One-bedroom apartment must be more than 50m², preferably 70m²
 - Bathroom must be separate to bedroom
 - Body corporate fees between \$3,000 and \$4,000
 - No redundant amenities in the building that will drive up body corporate fees (eg, pool, gym)
 - Small boutique apartment building
 - Rental yield of 4.5% or more
 - High rental population in the suburb
 - Annual average capital growth of at least 8–10% pa
- It is recommended that Julia and Chris waive the services of a buyer's agent to save money on fees (which are typically around 2% or \$6,000). However, in light of the couple's overseas travel plans and busy lifestyles, appoint a reputable property manager to take care of the investment.

RENTAL INCOME (\$350/WEEK)	\$18,200 pa
Less	
Estimated loan repayments (assuming interest rate of 7% pa)	\$25,624
Body corporate fee	\$3,000
Council rates	\$840
Water rates	\$720
Property manager (assuming 8%)	\$1,248
Insurance (contents)	\$250
Total property expenses	\$31,682 pa
Profit/loss	\$13,482 pa
Plus estimated total depreciation, year 1	\$12,000 pa
Total tax deductions	\$25,482 pa



The investors' plan of attack

- Research inner-city Melbourne suburbs to assess affordability and capital growth history
- Contact real estate agents and attend open inspections to identify what tenants want
- Finalise property 'shopping list'
- Go house hunting
- Arrange finance
- Purchase property
- Appoint property manager and advertise for tenants

Ongoing strategy

Julia and Chris are advised to hold the property for at least seven to 10 years, but should consider drawing on its equity within the next year or two to fund a second purchase. Assuming capital growth of 10% pa, the property could increase in value by \$40,000 within 12 months of purchase – which they could use as a deposit for another property. “The only roadblock for Julia and Chris is money to use for a deposit. However, once their investment property grows in value in the coming year or two, they could re-value the property, draw out the extra equity and use it as deposits for more purchases.” Upon their return from overseas, the investors could combine their annual tax returns and budget

surplus with equity from the property to increase their borrowing power further.” Should they choose to build a property portfolio in the future, Julia and Chris will need to turn their attention to cash-flow properties after buying the fourth or fifth property, in order to balance up their property portfolio and avoid the possibility of “hitting the financial brick wall.”

Capital growth projections

YEAR	PROPERTY VALUE
	\$400,000
Year 1 (assess equity to purchase second property)	\$440,000
Year 2	\$484,000
Year 3	\$532,400
Year 4	\$585,640
Year 5	\$644,204
Year 6	\$708,624
Year 7 (consider sale of property)	\$779,486
Year 8	\$857,435
Year 9	\$943,178
Year 10 (consider sale of property)	\$1,037,496

Assumptions: Capital growth of 10% pa; purchase price of \$400,000

Kick-off time

It's been an educational experience for the first-time buyers, who have gained a better understanding of how to make investing work for them. Previously satisfied with the long-term goal of investing in two or three properties over their lifetime, Julia says they now consider a far larger portfolio an achievable goal. The strategy has certainly given the young professionals some food for thought and opened them up to possibilities.

Having previously invested in shares, property investment is a novel concept for the couple. Julia says it's been a challenge thinking of property as a business transaction rather than a home. Taking the emotion out of the equation is indeed a common stumbling block for many new investors.

While the young professionals don't want the investment to curb their lifestyles by spending too much on it, Julia says she's now more aware of the power of her disposable income and has plans to put the surplus to better use. Despite the couple's original aim for the property's rental income to cover the mortgage repayments, they have now gained an insight into the tax benefits of negative gearing. Julia says she is keen to continue researching the Melbourne apartment market and the couple plan to put the strategy into action by early 2011. ■



Want to kickstart your portfolio?

Are you a hopeful investor but don't know where to start? Do you have a few properties under your belt but don't know where to step next? Have you accrued a serious portfolio but are financed to the hilt? If you're in need of some expert guidance and would like to be profiled for this regular feature, email your contact details and a brief overview to editor@yipmag.com.au

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