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Strategies and Types of Investment Properties

Investors,
I was reading an article in one of the papers on the weekend and they talked about suburbs where there is a price differential between the average top and the average bottom price ranges. They also talked about the ripple effect, where price movements in the popular suburbs move out to adjoining suburbs. Next to that was an advertisement for a new block apartment building to invest in. What should investors purchase and where?

I have recently had clients looking at a diverse range of properties, some because they liked the look of them, others because a buyer's agent has suggested them. From a long term strategic view, the purchase of those properties may not be in their best interests.

My view is that investing is about numbers, it is about creating long term wealth, by whatever your definition of wealth is. It may be simply having choice in the future. That means the long term strategy you embark on should be designed to achieve your goals as quickly and safely as you can.

Types of Property

There are many types of properties to invest in, residential or commercial, property trusts or physical properties, city or rural, inner or outer suburb, house or unit are all options available to an investor. Then there is a further decision, old or new, expensive or cheap. Which is best for you will depend on what your individual risk profile is and what your current and expected circumstances are and will be. I am not going to discuss the various commercial options here and while commercial property can have a part in an experienced investor's portfolio, it is a riskier strategy for a new investor than purchasing residential property.

There is no 'one' strategy, all can work and all property types can work but you need to know what best suits you in the particular stage of your investing cycle and your own circumstances. Let me illustrate with some examples, based on Victorian $450k established property (unless specified). I will cover the more typical circumstances an investor may be in.

The suggested options are based on not stretching yourselves where you no longer have a safety net of at least $10k to $20k available for when stuff happen (and it does), unexpected costs, tenant issues for a period, loss of job etc. As a general preference, clients should have access to about $120k available funds/equity before they look at purchasing another IP. For high income clients, this can be lower but you need to consider the risks.

Client - high income / low equity base

This could be a recently graduate professional earning good income who has not yet built a large deposit or perhaps a professional couple who have already used their available savings and purchased their own home first and have little available equity in that property yet. They have the ability to service any cash shortfall relating to the investment property (IP) from their own income. They have a high marginal tax rate.

What this investor should be placing importance on is capital growth, tax effectiveness and rent yield in that order.

The restriction will be the deposit they have available and the issue is that they need a property that is likely to build equity quickly. They will need to borrow at a high loan to value ratio (LVR) meaning borrowing as much as they can against the value of the property itself. The days of being able to borrow 105% of the price are long

gone, so they may be restricted to borrowing 90% to 95% of the purchase price. They need to have available the 5% to 10% deposit and another 5% plus for legal costs/stamp duty etc for an established property. For a $450k property, they will need a minimum of $55k of their own funds if they can qualify for a 95% loan (these may be at higher interest rates) or $75k for a 90% loan.

While rent yield is important, capital growth is more important as they have a high income already so showing they can service loans is not the issue, building their equity base is so they can purchase another property sooner than later.

The main options to be considered are:

- Buying off-the-plan (in Victoria) and take advantage of stamp duty concessions, so a $450k property, in a small apartment block, stamp duty may be as low as $5k. The funds to complete may be from $35k to $45k. The benefit of purchasing well, in 12 to 18 months when the property is completed, the IP value is greater than the purchase price. The other important benefit is the higher depreciation amounts that can be claimed for a new property, very worthwhile for a high income earner. The risk is that on completion the IP valuation comes up short so they will need to be able to fund the difference themself.
- Purchasing interstate, say Brisbane, for a $450k property, stamp duty is considerably lower ($8k), requiring own funds of $50k to $65k. The additional benefit is spreading the property risk and minimising the land tax bill.
- Purchasing at a lower priced bracket where there is opportunity to do some minor rejuvenation work to obtain capital improvement, as long as it fits within your available funds. Budgeting is critical.

Even with purchasing interstate, buying a newish property, built after 1987, is a preferred option. The Building Allowance is based on properties built after 1987. Obtaining the additional allowance can mean $'000's to an investor.

The properties I would keep away from include:

- House and land packages in outer suburbs. Although there are some stamp duty concessions and tax benefits, capital growth is likely to be minimal.
- More expensive properties, which require higher funds to purchase and erode your safety net.
- Large apartment blocks in Dockland type areas, lenders will not lend at high LVR's.

Client – medium income / high equity

This could be a married couple, one working and the other at home with children and have built up considerable equity in their own property over time or have a number of IP's already.

What this investor should be placing importance on is rent yield and capital growth in that order.

While they have a good equity base, the issue will be to access that equity by showing they can service the additional debt. I would drop the borrowing ratio or LVR down to below 80% (so mortgage insurers are not included) and lenders may have greater flexibility is lending.

The types of properties to consider include:

- 2 bedroom apartments/units in inner/middle suburbs, closer to facilities and transport offering consistent capital growth and good rent yield and demand
- Look to established older apartments offering opportunities for renovations and improvements, again improving rent yield and market value
- Houses on larger blocks in middle ring suburbs, where there may be opportunity to do subdivide and do a small development
- Regional properties that offer good rent yield and as you are borrowing < 80%, lenders generally have wider postcode areas than mortgage insurers

The properties I would keep away from include:

- House and land packages in outer suburbs. Although there are some stamp duty concessions and tax benefits, capital growth is likely to be minimal.
- Off-the-plan properties, which carry a higher risk and the tax benefits of depreciation are not as beneficial as for a high income earner.

Client – medium income / low equity base

This may be a wage or salary earner with average income, perhaps own their own home and have some equity in their own home or are still renting and have some savings for a deposit for a property.

What this investor should be placing importance on is rent yield equally with capital growth.

The issues are two-fold, low available equity and being conscious that servicing will be tight as far as lenders are concerned. Similar comments as to the high income/low equity base above apply here as well, with the funds needed to purchase from $55k to $75k. However due to the medium income, it will be less likely they will qualify for the higher 95% loan so will more likely need a minimum of $75k for a deposit and funds to complete.

The types of properties to consider are:

- A lower priced property, say $350k property where the stamp duty is lower, own funds required from $40k to $55.
- Areas to consider are the adjoining suburbs where prices are lower but rent yields higher.
- Also consider regional areas where the purchase price is lower and has a higher rent yield. Care needs to be taken to make sure lenders (and mortgage insurers) will lend to those postcode areas at 90%.
- 1 bedroom apartments (as long as they are greater than 50m2 in size) being less popular for an investor or owner-occupier so may be purchased at lower prices and yet still achieve reasonable rent yields.

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If you have any questions about any of these topics, give me a call.

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