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Helping People through Finance

The Strategy – Reasons Why

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Client – John & Annie Surname

Background

John and Annie own their own home (PPOR) in Spotswood. John works in Customer Service for Organisation and been with them nearly 9 years. Annie works in Administration for Company and has been in the role for 8 years although she was recently offered a redundancy package which she has taken where she finishes work early July 2011.

They are comfortable residing in Close Street and will continue to do so for some years. This property is owned by Annie who has 3 children which she has majority custody for and receives child maintenance and FTB.

The PPOR is currently mortgaged with ANZ and we recently refinanced this security to set up 2 new loan facilities to be used for investing purposes as the base funding for this investment property (IP) purchase. The term loan for $154k was an error by ANZ but we have left it as it will be used to provide the funds to settle for the next investment property (IP). The additional benefit of refinancing with ANZ was being able to obtain greater discount for their loans.

John owns an investment property, also mortgaged with ANZ. He recently transferred $126k from this loan which was available for redraw into the Close St loan. John has 2 children from a previous relationship and pays child support for them which is deducted from his pay each fortnight. John and Annie are both on all ANZ mortgages.

They want to continue a property portfolio to create long term wealth so they can afford a comfortable retirement in the next 10 to 15 years.

The End Goal

The long term goal is to own 5 to 6 IP's in the next 10 years to put themselves into a position to afford a comfortable retirement lifestyle. By that time the children will have left home or at least independent.

Servicing

Their serviceability or Maximum Borrowing Limits show a range of $85k to $478k based on their combined income with their existing debt to ANZ totalling $995k if fully drawn down

Issues

With the intention to build a portfolio as quickly and safely as possible, the issue will be to continue to qualify to borrow based on lenders servicing calculators. While we have taken the first step to establish a funding facility by refinancing their PPOR and restructuring their borrowings to minimise their non tax deductible interest costs, with ANZ funding another $154k facility, it has decreased their ongoing borrowing ability.

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The second issue to consider is the redundancy Annie has taken and what the longer term outcome may be. While she has negotiated a healthy redundancy package and been smart enough to roll this into the next tax year, what her next stage of employment may be needs to be considered. It is possible that she will seek work in the industry sector in HR with a package upwards of $200k pa and if so, we will need to reconsider ownership options and type of property purchased.

The next issue to consider is that John's existing IP takes him into having to pay Victorian land tax, and as that is a progressive tax, it is not advisable to increase his land holdings in Victoria.

They have clean credit files although both have a number of lender enquiries made over the last 4 years which may lend itself to consider a lender that does not credit score and we keep the loan to value ratio (LVR) quite low

With the work John does, his income is around $75k per annum with shift work and allowances. From this $7k pa is deducted for child support. John receives $19k pa gross rent for his IP.

Annie's current income is $67k pa. She receives a further $9k for child support and $8k for FTB.

Strategy
The first step was to arrange a line of credit facility (LOC) secured against their PPOR. This was for $200k with ANZ. In conjunction we applied to 'move' the $126k redraw funds from the New St loan (IP) to reduce the loan on Close St (PPOR). As part of the ANZ restructure, we also paid out the $39k car loan. This should have reduced the PPOR loan to approximately $154k, making the overall loan to value ratio (LVR) of 48%. This should reduce the non deductible interest cost on Close St and the car down from approximately $1,700 a month to $900 a month. As well as doing this, ANZ set up a new term loan for $154k which we have left in place and have moved those funds into their PPOR Offset account in the short term.

The effect of a $354k investment funding facility will easily allow them to fund the settlement of 2 IP's or even 3 IP's if so chosen and still leave them with a healthy safety net to fund any rent shortfall.

The LOC will just be used for investment purposes so not to contaminate the purposes when claiming the interest costs as a tax deduction as will the new $154k term loan. We will use this to settle the next IP purchase.

The second step will be to obtain a pre-approval to purchase their second IP. We will work on the basis of obtaining this pre-approval while Annie is still employed in her current role. If her new role is significantly different in terms of income, we will revisit the ownership and type of property to be purchased.

The third step is that once this pre-approval is in place, is to purchase their second IP.

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After that, it will be a review of the strategy with the thought that the next IP after that may be purchased as a more negative geared property in Annie's name based on the premise her income is significantly higher.

Ownership
The next IP will be purchased in John's sole name. The reason for this is the type of property to be purchased to enable them to qualify to borrow again and the existing negative gearing on John's first IP.

Property Type
The next purchase will be an established median priced property up to around $420k. The reason for this is that their borrowing capacity is quite low across most lenders due to their facilities with ANZ, so using the new $154k term loan as funds to settle, it will mean they can apply for a loan of around $290k at an LVR of 68%. The rent yield is the critical component for this purchase which needs to be in the 4.6% to 5.5% range making it after tax cash flow negatively geared by about $9k pa. Any shortfall will have to be funded from the new ANZ LOC facility.

It could be a 2 bedroom unit/apartment, 5 to 10km from the Sydney or Brisbane CBD, it could be a Defence Housing Association (DHA) property in NT or even Townsville. It could be a free standing house in Hobart or other parts of Tasmania. The critical component is the rent yield which will be needed to enable them to borrow again for their next IP. Some of the benefits of purchasing interstate is two fold, often a lower stamp duty and generally in different growth cycles to Victoria.

It is not critical for this property to have an expectation of high capital growth. John and Annie have two properties already in good areas where capital growth is expected to continue. Their next properties need to have a higher rent yield component to enable them to borrow again, the higher the better.

Loan to Value Ratio
A property around the $420k purchase price seems to be suitable due to wanting to purchase 2 IP's in the next 12 and to utilise their existing loan facilities. Using a loan of approximately $290k from a new lender with their existing ANZ $154k as funds to settle, this will give a LVR of 68% which is very comfortable for lenders. This will leave their ANZ LOC of $200k fully intact to fund the rent shortfall of New St as well as the new IP and more than sufficient funds to settle on another IP purchase.

Loan Structure
The loan structure will be one offering Interest Only variable rate Investment loan. The reason is to take advantage of only paying interest to reduce the cash outlay and claim maximum tax deductions for the cost.

Loan Selection

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The 4 loans considered for IP #2 are based on the lenders offering competitive products and can meet the lenders borrowing capacity with Homeside (NAB) offering the lowest long term cost (as per the Comparator model). This needs to be confirmed as servicing is tight on both Homeside and PLAN Lending (both NAB owned) so it may depend on the rent yield achieved.