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Helping People through Finance

The Strategy – Reasons Why

November 2011

Client – Mark Surname

Background

Mark owns his own home (PPOR) in Altona Meadows. Mark is a Technical Director for Company Pty Ltd and has been in the role for over 10 years.

Mark is in a defacto relationship with Eliz who shares the home which they purchased about 2 years ago. The PPOR is in Mark's name.

He has a clean credit file. The PPOR was recently refinanced with Suncorp for the purpose to obtain a better interest rate, leaving it as a principal and interest (P&I) loan with offset and to establish a $240k line of credit (LOC) facility that will be used as the basis to fund settlement of one or two investment properties (IP) and to enable Mark to fund any cash shortfall from these IP's.

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. While Mark does have some superannuation, a divorce some years ago considerably reduced the balance and while Mark is putting further funds into it, he is looking at alternative ways outside superannuation to build his retirement nest egg.

Servicing

Their serviceability or Maximum Borrowing Limits show a range of $519k to $803k based on their Mark's sole incomes for the first IP so initial lender selection should not be a major issue but care needs to be taken to ensure it is from lenders with the lower maximum borrowing capacity range.

Issues

With the intention to build a portfolio as quickly and safely as possible, the issue will be to minimise the Funds to Complete for the first IP using the Suncorp LOC while still allowing a health safety net. It is also to allow Mark to purchase the next IP as soon as it is comfortable to do so, so we will look to use a loan to value ratio (LVR) of around 85% for the first purchase. Mark's income can easily show servicing for loans to be able to purchase an IP at the median price range.

With the work Mark does, his income is around $158k per annum even though he does salary sacrifice $2k per month into superannuation. His monthly net salary amount for 2011 is $7,798 per his last payslip. He can easily show servicing capacity based on his income at this stage.

While Eliz runs her own business, her net taxable income is not included in these calculations. Mark intends to continue working for another 10 to 15 years.

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Strategy

The first step was to arrange a line of credit facility (LOC) secured against his PPOR. This was for $240k. This will just be used for investment purposes so not to contaminate the purposes when claiming the interest costs as a tax deduction.

The second step will be to obtain a pre-approval and then purchase an IP in Melbourne in the short term. This property will most likely be an established 2 bedroom unit in inner suburbs of Melbourne where there is a strong demand from both owner occupiers and tenants so achieving capital growth and a reasonable rent yield. For the first IP, capital growth is more important with a view to revaluing and refinancing this IP in the next 2 to 3 years to continue the strategy to build the property portfolio.

The third step is that once this IP has been purchased, to obtain a pre-approval for a loan for a second IP. This will more likely be an established property where some work needs to be done to add value and increase the rental yield. It may also be an IP in another state or even to consider an off the plan apartment (OTP) in Melbourne to better utilise higher depreciation benefits and lower stamp duty costs.

After that, it will be a consolidation of the strategy to allow time to understand the cash flow requirements, any issues with tenants and other professionals and for capital growth to occur.

Ownership

The first two properties will be purchased in Mark's sole name. As there does not appear to be a significant risk of being sued in his personal name from his professional employment, there are significant tax advantages of holding a negative geared property in the short to mid term.

Property Type

The first purchase will be an established median priced property of up to $450k, perhaps a 2 bedroom unit/apartment, close to the CBD. The rent yield is expected to be in the 4.2% to 4.5% range making it slightly after tax cash flow negatively geared by about $200 a week. Any shortfall will have to be funded from the new Suncorp LOC facility. A newer type property with construction date after 1987 can be advantageous as additional building allowances can be claimed, or a property where immediate improvements can be made to increase value and/or rent yield. It could be in a block purchase situation where the sub division, strata titling and exterior renovations are done at an inclusive price.

Loan to Value Ratio

A property up to $450k purchase price seems to be suitable due to wanting to purchase 2 IP's in the next 12 and to minimise their cash outlay. Using a LVR of 83% plus capitalised lenders mortgage insurance (LMI), will bring a final LVR to around 85%. The Funds to Complete will be approximately $96k, which they will use their Suncorp LOC facility. This will leave a balance of $144k.

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The borrowing capacity for the second IP ranges from $307k to $663k with a purchase price of around $420k and using $99k from the LOC to settle, this will leave $44k in the LOC to fund any rent shortfall after tax.

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 and to use any surplus funds to pay down the existing PPOR loan or putting the funds into an offset against the PPOR loan.

Loan Selection
The 4 loans considered for IP #1 are based on the lenders offering competitive products but have the lower borrowing capacity (leaving the other lenders for the next IP), with ING Direct offering the lowest long term cost (as per the Comparator model). An additional benefit is that Mark was a recent customer.
Note that this is based on incomplete data as not all lenders have passed on the recent RBA cash rate decrease. This will be revisited after 17th November 2011