

Your no-nonsense guide to property investment *Part 1.*

One of the many benefits of investing in property is the control you have over your investments. However, your success largely depends on which strategy you adopt and how you implement it. In a three-part series, **Bill Zheng**, CEO of Investors Direct, outlines the upsides and downsides of each approach

Property investors are a unique breed. Investors in many other types of assets (like shares, managed funds, indirect property, deposits, super, etc) play a relatively passive role in the investment decision-making process; the majority of these investors allow their advisors (fund managers, etc) to take the driver's seat and make their decisions for them.

Direct property investors, on the other hand, are fully responsible for their success or failure – they're fairly and squarely in the driver's seat.

Strategies

It's a difficult role to play, and an even more difficult role to succeed in. I believe there are three types of systems a property investor needs to master.

There are three types of systems property investors need to master



These three systems are:

1. Property systems
2. Money systems – your capital, cash flow and finance plan
3. People systems – your team and self management

In this article I'll discuss property systems. In my opinion, there are generally two types of residential property investment strategies:

- Passive (or defensive)
- Active (or offensive)

Passive (defensive) strategies

Passive strategies involve investors exerting a standard amount of effort; the investment has a standard risk profile and will get a standard return. The investment requires a normal deposit (3–20%) and normal finance (97–80%), it will receive natural capital growth (3–10% pa) and a natural yield (2.5–8%). Passive strategies include:

- Cash flow vs growth properties
- Houses vs apartments
- New vs old properties
- High price vs low price properties
- Off-the-plan properties
- Special purpose properties

Active (offensive) strategies

An active strategy involves an investor exerting more effort on a more 'creative' type of opportunity, which often has a higher risk profile and return. These strategies usually involve a creative deposit (<3%) and a creative finance solution (>97%). The rewards for this extra effort are instant capital growth (5–25%) and a higher yield (>8%).

Active strategies include:

- Renovation
- Development
- Unconventional

So what are the major advantages and disadvantages of the various strategies? And which one will suit your situation?

Choosing your strategy:

Cash flow vs growth

Strategy #1

Cash flow properties

These are properties with a low capital growth profile of 4–6% and a high rental yield (return) profile of around 6–10%. Occasionally, though, the capital growth achieved for these types

of properties can be very high. But typically this is only for a short while.

↑ Upsides

The main advantage of cash flow properties is the positive or neutral cash flow they generate. You can't lose having money in your pocket (unless you get in too late).

Typically, these properties are located in regional areas and so they tend to have lower entry prices (as well as lower stamp duty and land tax) – so this makes it easier for investors who don't have much equity or income. Moreover, investors can use the surplus cash flow to pay down principal to get more equity for future investments.

Because of the popularity of these types of properties, it's not uncommon to occasionally achieve strong capital growth gains due to the demand for high yield properties.

Regional areas tend to have slower capital growth unless there's an economic change to the area. For example, North Queensland is currently experiencing growth in property values as a result of the

mining industry. Traditionally, properties in regional North Queensland have been strong cash flow properties. However, the recent increase in population has driven the demand for homes and rental accommodation, which in turn has pushed the price up for existing properties. These properties are now giving good growth.

Buying into the area now, however, would have a higher entry cost and would reduce your ongoing cash flow. Should the mining boom cease or slow down, the demand for properties would drop, which in turn would have an impact on property values. This shows that regional centres can in fact offer both strategies. However, you should be careful that the growth is not short-lived.

From a financial perspective, the income generated from the asset means it's easier to get a full-doc loan with a higher loan to value ratio (LVR), which allows you to borrow more and requires less of your money.

↓ Downsides

Because you're generating an income from the positive cash flow, you pay tax along the way. You get taxed on this extra income and money in the tax man's pocket is going to make it hard for you to create serious wealth.

Because these properties are usually in regional or outer areas they can be quite sensitive to economic cycles. Therefore, when compared to properties located closer to the centre of our major cities, these properties will generate lower capital growth over a longer term.

There are also potential higher costs associated with maintenance and more tenancy problems due to socio-economic factors.

From a financial perspective, it's harder to get low-doc or no-doc loans for some regional properties due to postcode restrictions imposed by lenders, mostly due to their smaller populations. The result is lower leverage, which will reduce your return.

Strategy #2

Growth properties

Growth properties have a higher capital growth profile of 7–10% (and occasionally over 12% for a short period) and a lower rental yield (return) profile of 3–5% rent (occasionally below 2.5%).



Regional areas tend to have slower capital growth unless there's an economic change to the area

↑ Upsides

The main advantage of growth properties is the fact that their locations are usually inner areas and high population areas which aren't affected as much by economic cycles and interest rate changes.

Therefore, these properties usually have higher and more consistent capital growth over a longer term. This means that investors can generate more equity in a quicker period of time, which can allow them to invest further.

The government also makes it attractive for investors to purchase these types of properties by offering tax benefits via negative gearing and delayed capital gains tax (CGT).

In terms of finance, it's easier to get low-doc and no-doc loans for these types of properties. Most lenders view these types of properties as less 'risky' than regional properties, mainly because of the larger populations in these areas.

Therefore, there's often less risk of tenancy problems due to better socio-economic conditions and the fact that there are more buyers in these areas, in case the property ever needs to be sold quickly.

From an investor's perspective there are more finance options available for these properties. High leverage is available as it's easier to get a low-doc or no-doc loan.

↓ Downsides

The main disadvantage of growth properties is the negative cash flow if you take on a normal mortgage at a high leverage level.

Added to this is the fact that these properties are usually more expensive than cash flow properties, in terms of purchase price, stamp duty and land tax.

So, as we're seeing in a number of markets across the country at the moment, it's often harder for beginners to enter the market because there's greater demand than supply for these types of properties.

Furthermore, in the short term, there's no guarantee for capital growth every year – you may bet on the wrong horse.

The main disadvantage from a financial perspective is that it gets harder to get full-doc loans to access cheaper interest rate mortgages as your portfolio gets bigger.



Houses vs apartments

Generally speaking, in recent times there's been an increase in popularity of apartments, in comparison to houses.

Families are getting smaller and people have less time on their hands for property maintenance.

Tenants gravitate to properties that meet their needs. These needs will largely depend on how tenants prioritize and weigh up the property's advantages and disadvantages, and how they feel about the notions of space, time, enjoyment and money in relation to a specific property.

Strategy #3

Houses

↑ Upsides

Houses have typically shown more consistent growth over the long term in established areas. Therefore, purchasing properties with high land content is one way to increase your chances of securing better future growth if the property is in an established area.

You usually own the land and therefore you have greater control over what to do with it. This means there are more options open to you (depending on Council regulations in the area) to modify the property and add value.

Houses are typically more sought after and this usually makes it easier to obtain finance. However, townhouses are now becoming very popular as family sizes are decreasing and the number of retirees is increasing.

↓ Downsides

It can sometimes be difficult to obtain a good level of rent from big houses. Be careful because sometimes houses offer lower rental returns as a percentage of their value.

Sometimes there can also be higher maintenance costs involved.

Strategy #4

Apartments

↑ Upsides

One of the main advantages of investing in apartments is that they tend to have higher rents as a percentage of their purchase price.

Moreover, apartments frequently achieve returns as good as those of houses in areas that are fully built up with height limit restrictions on further development.

Over the last decade, units have become popular with the younger generation and empty nesters.

Apartments meet the needs of these demographics as lifestyle trends change. For example, units are typically less labour intensive in terms of maintenance.

Many apartment complexes also have shared amenities such as pools, tennis courts, gyms, etc, which help create a sense of community amongst residents.

↓ Downsides

The main disadvantage of investing in apartments is that they typically show less consistent growth in areas that are not fully built up.

Owners of units also usually have less control over their assets as most changes to the property require approval from the Body Corporate. Therefore, the opportunity for the owner to add value to the unit is restricted.

Owners also have to contribute to the running of the Body Corporate, so compulsory fees are generally higher.

Sometimes it's also hard to obtain good finance for certain types of apartments, such as company title properties and very small units (under 40m²).

New vs old properties

Strategy #5

New properties

↑ Upsides

New properties are attractive to passive investors who are time-poor and would like to have a property that requires little effort on their behalf. There's usually lower maintenance involved, and if there happens to be any defects after completion, the builder or builder's insurance should cover the cost.

New properties are appealing to tenants as they usually have lots of light and space, and new apartment complexes may also have amenities such as a swimming pool or gym. Tenants with good incomes are often prepared to pay higher rent for new properties, particularly if the property is located close to their workplace.

From a tax point of view, new properties usually offer higher or longer depreciation benefits, not only from the fixtures and fittings, but also from capital works. It's possible for investors to use these tax benefits to assist with monthly cash flow.

↓ Downsides

The main disadvantage of purchasing a new property is that the cost to purchase may be higher than an old property in the same area, as developers have to cover their costs and profit margins.

Many people who purchase new properties may make emotional rather than business decisions, as they may have fallen in love with the look of the place. If they've paid an inflated price for the property, it may take longer to realize capital growth.

Growth may also be affected if there are a few properties that are very similar



New properties don't allow much room to add value by renovating as all the work has already been done. Unless you purchased at well under market value, you'll need to wait for natural capital growth to occur

being sold at the same time, such as in a new development.

A few hasty re-sales can affect the values of all properties in the immediate area. This can have an impact if you're trying to sell a property or are trying to release equity from your own property. If properties in the area have been sold for lower prices, it will reduce the market value of your home.

As a general rule, brand new properties don't allow much room to add value by renovating, as all the work has already been done by the developer. Unless you purchased the property at well under market value, you'll need to wait for natural capital growth to occur.

Strategy #6

Old properties

↑ Upsides

One of the biggest advantages of investing in old properties is the fact that you get less price fluctuation than new properties in the same area.

You have the ability to add instant value through renovations, subdivision or development. Some investors have even managed to get their property for 'free' by subdividing a large block and selling off a portion of the land.

It's been proven that scarcity of land is what drives property values upwards, and older properties generally have a larger land component.

Investors can be more certain that the property they're purchasing has a 'true' market value, with no profit margin set by the seller. They're usually found in well-established suburbs that can demonstrate consistent growth.

↓ Downsides

High maintenance costs are possibly the biggest disadvantage of investing in old properties.

There may also be a loss of rental income if renovations are required.

It may be also harder to attract good quality tenants to an older property, unless it has had some renovations to modernise it.



Affluent suburbs typically have strong demand, limited supply and solid past growth performance

Also, tax benefits are not as good with old properties due to lower depreciation values.

Furthermore, rental returns may not be as high if the property is run-down. This can impact on your monthly cash flow as the rental yield will be lower than that of a new property.

High vs low price properties

Strategy #7

High price properties

↑ Upsides

High price properties are usually in well-known suburbs and come on to the market irregularly, so there are fewer of these available.

The marketing effort is considerable for this type of home as prestige is something people strive for. Therefore, it's relatively easy to track when these types of properties become available.

Affluent suburbs have strong demand, limited supply and typically

have solid past growth performance. These factors will continue to keep the prices increasing.

The high price of these properties will equal a higher rental figure, which could put them out of the reach of mainstream tenants. Therefore, the quality of tenants should generally be of a high standard.

↓ Downsides

In times of economic downturn, it's the higher priced luxury items that suffer first. As there's less demand for these properties, there will be very little capital growth.

Having the best house in the worst street or area doesn't give you good capital growth. It makes more sense to have an inexpensive house in an expensive suburb.

From a financial point of view, it can be harder to arrange finance on a higher priced property. Don't forget that lenders base the amount that they're willing to lend on how quickly they

could sell the property to realise a debt. Therefore, the higher the value of the property, the less demand there is from the general population to purchase it.

For example, a 60% loan to value ratio (LVR) for a \$3m property looks decidedly pale against the easily achieved LVR of up to 95% for a more modestly priced property of \$500,000.

You can also expect higher stamp duty and land tax costs if you invest in high price properties.

Strategy #8

Low price properties

↑ Upsides

Low price properties in established suburbs can handle economic downturn better. The lower price will mean these properties are still relatively affordable and the lower mortgage balance allows investors to continue to purchase in difficult times.

Given that there are more lower priced properties available and they're spread throughout most locations, an investor can have a better spread of suburbs to buy into. This means that these types of properties have a more stable performance if they're priced around the median price of the suburb that they're located in.

Greater diversification in your property portfolio reduces the risk of not having sufficient tenants in the market for this type of property, or seeing a downturn in one suburb as opposed to another.

These properties also have lower stamp duty and land tax costs.

↓ Downsides

The disadvantage of the higher availability of lower priced properties means that there will be more competition for homebuyers. Therefore, it could take an investor a lot longer to find and purchase a property.

The high price may also make it harder to find tenants if the area isn't supported by infrastructure.

A lack of public transport, shops, schools, etc in the area will make the property less appealing to prospective tenants, for example families with small children.

If the property is too run-down the rental returns will also be much lower, which in turn could attract lower quality tenants.

Furthermore, renovating the property to gain equity and increase the rent could mean over-capitalising, depending on the area.

Strategy #9

Off-the-plan properties

↑ Upsides

Off-the-plan purchases have a lot of the advantages I've already touched on with new properties. An off-the-plan purchase is a brand new property which has higher depreciation benefits.

The stamp duty payable on the purchase is reduced because the property isn't yet completed.

The Foreign Investment Review Board will allow an overseas investor to purchase an off-the-plan property, where they can't purchase an established property.

Perhaps one of the biggest advantages is that there's potential to secure the property without putting any of your money down.

Some developers accept deposit bonds to cover the deposit instead of you having to use your own cash. If the property isn't completed for a couple of years, this is a much cheaper option and allows you the flexibility of using



One of the biggest advantages of investing in an off-the-plan property is the potential to secure a home without putting any of your money down

your cash for something else. So there's a potential equity gain for the investor, even before settlement – but only if you get it right.

↓ Downsides

There have been occasions where properties purchased off the plan may have dropped in value by the time the property is completed and ready to settle, and investors have subsequently found themselves out of pocket.

These developments tend to be heavily marketed by skilled project marketers and you have to be careful to see through the spin, and focus on the underlying fundamentals of the project itself.

The area and type of product that's being developed for some new developments may not have been tested before. This is a warning sign. Past performance is the best indication of future performance. Therefore, without past performance, the future performance is unknown. This means that there's more scope for the purchase price to be set artificially as there's no precedent. You need to factor this risk into your decision-making process.

Paying the upfront deposit prior to any valuations being completed commits you to the property before

you have a true 'value' on the property. Remember, you haven't actually 'seen' the property you're purchasing.

If there are a number of large developments going on in the same area, this over-supply can reduce the value of the property you've purchased even before it's completed (remember Docklands in Victoria?).

It's also important to remember that if a certain percentage of the properties in large developments aren't sold before construction, there's no guarantee the project will commence, which means you may have lost valuable time and missed out on other property opportunities.

Special purpose properties

Strategy #10

Serviced apartments

↑ Upsides

The main advantage of investing in serviced apartments is that it's less taxing on your time.

As these types of properties are managed, you don't need to worry about tenants and maintenance yourself. You can usually command a higher rental return if the property is managed properly.

You can usually secure a higher rent from display homes and maintenance costs are non-existent for the contracted period



↓ Downsides

The main drawback of serviced apartments is that it's harder to obtain finance for these types of properties. The main reason is because serviced apartments are classified as commercial property. Commercial lenders won't give you the same loan LVRs as they would on residential properties. Typically, they're around 65–80%.

These types of properties can also be hard to resell, given that the market for serviced apartments isn't nearly as large as the residential property market.

Moreover, their capital growth is tied into yield and how well the apartment is operated, not necessarily reflecting local property prices. In other words, the value of the property is affected by the financial viability of the operator, which typically isn't something you can control.

Strategy #11 Display homes

↑ Upsides

Display homes are usually built to above standard quality because they're used by developers as their showcase.

You can usually secure a higher rent than from normal properties, which is guaranteed for a contracted period because the developer will continue to use the property.

Your maintenance costs are non-existent for the contracted period and there's also no need to look for tenants.

↓ Downsides

Display homes can be overpriced in compensation for the fact that you're receiving a guaranteed rental return that's higher than the market rate. You need to be careful as the developer's financial viability can affect the rent that they guaranteed.

It can also be hard to obtain finance from some lenders due to difficulties with obtaining an accurate valuation, as well as the commercial nature of the arrangement you're entering into.

On top of this, these types of properties are usually in outer areas which have historically displayed slower long-term capital growth.

Strategy #12

Student accommodation (managed)

↑ Upsides

Much like serviced apartments, student accommodation that's managed can achieve a higher rental return if it's managed properly. Similarly, you

don't have to worry about tenants and maintenance.

The biggest advantage of student accommodation compared to serviced apartments is the purchase price. Student accommodation is typically more affordable.

↓ Downsides

Student accommodation can be hard to resell sometimes due to its special purpose nature.

Like serviced apartments, the growth of student accommodation is tied to yield and how well the unit is operated – not necessarily reflecting local prices.

The value of the property is also affected by the financial viability of the operator. A lot of lenders are reluctant to lend on student accommodation due to the size of the property, as student accommodations are frequently studios or one-bedroom apartments less than 40m².

Strategy #13

Renovation strategy

↑ Upsides

As noted in strategy 6, there are many advantages of renovating older properties. The main benefit is the ability to instantly create additional equity that you can access for further investment or to create an equity

'buffer' to manage your risk better. Spending money on a renovation if carried out well is a very efficient use of money.

Renovations don't have to be major to add instant value. Cosmetic renovations have lower town planning requirements and don't carry the risk inherent in building.

The increased value can not only create more equity, but also enable a higher rental return. It can also lead to higher tax advantages due to higher depreciation.

Sometimes you can buy properties under market value that need renovations. However, these properties in recent times are highly sought after and so competing parties frequently bid this benefit away.

Another positive is that if you're purchasing these types of properties, most of the money you pay is going to the 'land component'. It's the land that appreciates in value, while the building on the land depreciates. So, with a higher land component, you're ensuring solid future growth.

↓ Downsides

Inexperience in renovation, however, could cost you more money. For example, you might not see trouble spots until halfway through a renovation (electrical, plumbing or structural issues). It's also easy to underestimate the time, cost and work involved, particularly if you don't anticipate structural, engineering or council permits.

You should ensure that the money spent is going to increase the value of the property and that you haven't over-capitalised. Will you be able to create enough equity on the sale or revaluation to make it worth your investment in time and money? Can you increase the rent sufficiently to make it worthwhile?

Carrying out a renovation requires a lot of work if you do it yourself, and a lot of management if done by others. It also takes a lot of time to find the perfect property that will make the numbers work.

Strategy #14

Development strategy

↑ Upsides

The main benefit of developing is the potential to make a good profit



Renovations don't have to be major to add instant value. They can be as simple as a coat of fresh paint or new floor coverings

above your costs by creating the equity instead of waiting for it over time with capital growth.

Developing also allows you to express your creativity.

There's no question about it, developments are exciting projects to work on and there's a certain amount of pride that goes with completing a project. And you also get to call yourself a developer!

From a financial perspective, the main benefit of development is that you have the potential to obtain finance and capital based on the strength of the deal, instead of your own personal equity or income capacity.

There are multiple exit strategies to make money, depending on how quickly and how much profit you want. These exit strategies include: subdivide and sell; sell with plans and permits; secure plans and permits to construct; subdivide and keep, etc.

↓ Downsides

However, where the potential return is higher, so is the risk. I could write another article just on the complexities of the financial risk involved in development, let alone the planning risk, building risk and selling risk!

Developing is a complex business. It's easy to make a loss if you don't know your craft. It requires good commercial skills and people skills to be completed successfully.

Developing also requires good timing. You have to be able to read the property market extremely well.

However, the development strategy might not necessarily be the most efficient use of money due to long lead times. There are potential delays in every step of the development process, from planning, permits and finance right up to construction.

Therefore, development frequently requires a larger capital commitment than originally estimated from the developer, as these delays cost money. So you have to factor in that you'll have a lower income while holding the site.

Strategies 15 to 19

Unconventional strategies: wraps, rent to buy, vendors terms, joint ventures, options

↑ Upsides

These extremely creative property strategies usually combine with the other property strategies we've already outlined, and are attractive for a number of reasons.



Several key benefits are that these strategies require very little or no money down, they have positive cash flow and also create instant equity on entry and/or exit.

↓ Downsides

Don't underestimate how hard you'll have to think, how hard you'll have to work and the amount of time you'll have to spend learning and executing your chosen strategy.

To make unconventional strategies work, you also need to be very entrepreneurial – and the fact is that entrepreneurship is not necessarily something that can be learnt.

Moreover, because these strategies are so advanced and different, you can run into significant difficulties in managing the expectations of investors, vendors, real estate agents and tenants/purchasers. These people are all important parts of your strategy and more often than not will not be familiar with these concepts. So you'll have to educate not only yourself, but them as well.

You can also expect extra legal and accounting expenses if these are the types of strategies you want to pursue.

Which strategy is best?

All of the strategies outlined above have their own unique characteristics, and none are any better than any other.

We have clients who make good money out of all of these strategies.

Some investors focus on one strategy, whereas others spread themselves across a number of strategies and are equally successful

Some focus on becoming efficient in just one strategy. Others, however, will spread themselves across a number of different strategies and be equally as successful.

But which strategy suits you? Are you better off with a passive (defensive) or active (offensive) strategy?

I think the best piece of advice I can give any investor is: there's room for both.

Firstly, you always need to have a passive strategy in place. A passive strategy will ensure that you get more predictable results – you're guaranteed 'not to lose' in a sense.

If you incorporate this type of strategy into your property system, you'll ensure that you're less emotional and more consistent. It also means you'll always be making good use of your time, which has to be a major consideration for any investor.

Secondly, you should use active strategies at the right time. If you start with nothing or very little, you can start with more active strategies to build your equity and/or cash flow, and be good at one thing first.

My advice would be to focus on one strategy initially and hone your skills.

This is your best bet to make serious money before becoming diversified and defensive.

Be careful though. When considering adopting an active strategy to take advantage of a great opportunity, the time to do it is only when you're sure it won't affect your overall financial stability.

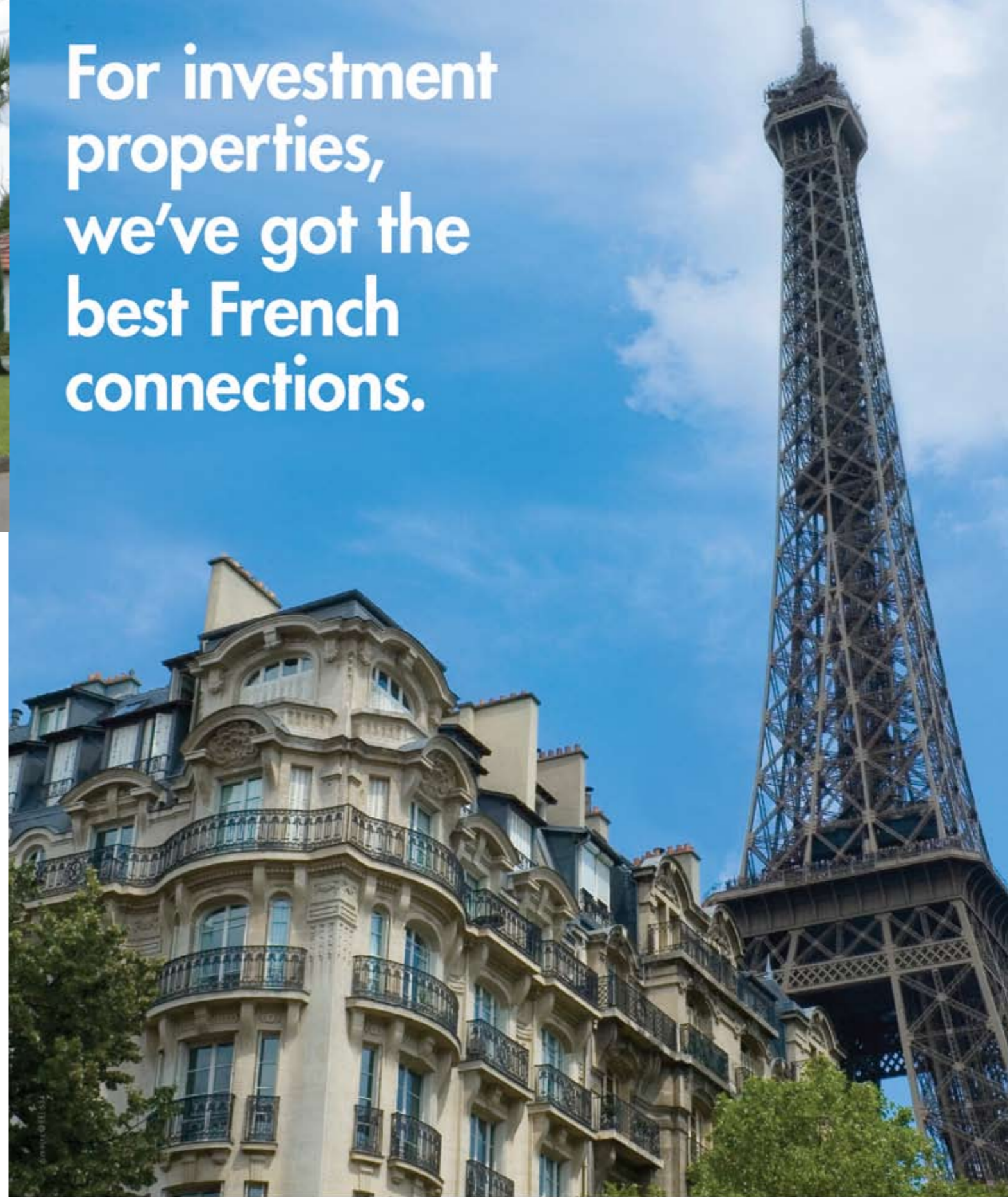
Talking about financial stability, next month we'll delve into the finance side of your property investment strategy. We'll explain what a money system is, how it underpins your property system, and how if you don't have a money strategy that works effectively, your property strategy, no matter what it is, can suffer. ■

Lee Dittmer, Vincent Power, Rhoda Downie, Renee Matthews, Doug Bannister, Regina Looi, Lynda Heise and Tim Riley also contributed to the article. Investors Direct™ is a property finance company that provides financial solutions exclusively for property investors. For further details, go to www.investorsdirect.com.au



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