The 3 Rules for Property Investment Selection

Part 3: Selection & Structuring

Now that you've read through our '3 Rules for Property Investment Selection' – Part One: The Three Rules and Part Two: Locations, hopefully they are starting to make sense. They are logical and proven steps towards sensible selection and provide the correct mechanisms for investment property ownership.

The next step is to understand the financials behind investment property ownership so that you can not only make a sensible selection but also one that is structured correctly and is financially sound so that it has minimal impact on our daily budgetary constraints.

On that basis I have prepared an example investment analysis on a property selected using the 'Rule3' parameters and adding average household income levels to see how it all works.

Martin Josselyn, Rule Three Property Performance

Martin Josselyn is a licensed agent, qualified financial planner and mortgage broker and has over 15 years of experience in direct property investment portfolios

Assumptions

Let's have a closer look at the assumptions:

- Purchase Price: I've used a standard piece of stock that the AR Development Group develops in Brisbane. It is a 3 bedroom, 2.5 bathroom Townhouse situated in Wynnum (14 km's from the Brisbane CBD). It's price is $397500.

- I've assumed that our investors are a couple who have a combined household income of $120,000 per annum. I've suggested that one income is $80,000 and that the other is $40,000 and I have apportioned the ownership for taxation purposes at 99% - 1%, so this analysis is largely dependent on the $80,000 income stream.

- I've assumed that the investors are using equity in another asset (normally your own home) to purchase the investment property. In other words, the loan for the property will be for the purchase price and for the associated expenses in buying the property. The loan in this instance is for the purchase price of $397500 + costs of $16158 (made up of stamp duty $12338, loan establishment fees $1820 and conveyancing charges of $2000) adding up to a total loan of $413,658.

- Independent rental assessments suggest that the rental income achievable for the property on a weekly basis will be in the range of $410 to $430 per week and as such I have adopted the lower figure of $410p/w, for a total annual rent of $21320. Rental figures for existing clients in this area supports this figure.

- The loan as previously mentioned is for a total of $413,658. For the purposes of the example I have assumed that the investors still have a home mortgage as is generally the case and therefore all principal reduction should be directed to the home loan in priority to the investment loan and therefore I have adopted the interest only scenario in the first instance at a rate of 5.05% and an annual repayment required of $20890.

- In relation to the ongoing expenses for the property I have assessed them to be a total of $7369 p/a. (Made up of agents management fees $1759, agents letting fees $410, Rates $1600, water $550, landlord protection insurance $750 and Body Corporate Fees of $2300)

- And finally I have assumed the Capital Growth Rate at 6%p/a and CPI at 4% p/a.

Analysis

In the attached analysis document you can see that based on the above assumptions the following financial scenario unfolds:

- **Income:** $21320
- **Interest:** $20890
- **Expenses:** $7369
- **Pre Tax Shortfall**: -$6939
- **Total Tax Deduction:** $37683 (deprec' fix & fittings, building allow, loan cost write off)
- **Tax Rebate:** $5609 (based on $80,000 – 99% / $40,000 – 1%)
- **After Tax Shortfall**: $1330
- **Nett Weekly Cost:** -$26 per week

In this scenario you can plainly see that the nett cost to the investor is $26 per week which most investors can manage with careful planning.

The concept of wealth creation using leveraging strategies can clearly be seen here where it becomes very apparent that if there is a secret to wealth creation then it surely must be that it is to-

'control as much of an asset base as possible, for the smallest amount of out of pocket cash flow so that when you achieve growth you achieve it on what you control not what you contribute' (*Martin Josselyn 1994)*

In the above scenario the 400K approx. asset is controlled for $1330 or $26 per week out of pocket expense. Let's assume that the 6% growth rate used is correct, then on that basis the asset grows in value by $24000 p/a compounding thereafter for a cost of $1330 p/a reducing as the rental figure lifts over time. It's a pretty good return on the out of pocket expense and its certainly more effective than trying to save you way to retirement by putting the extra $26 per week away in a savings account.

Summary

Of course there are risks in any scenario but it's my submission that if the '3 Rules' for selection as discussed in parts 1 & 2 of this series are used and that if sensible structuring and financing is practiced then the likelihood of major issues occurring is mitigated and for most investors that I've dealt with over the years leaves them in strong position to make educated decisions and in time assist them to achieve significant financial goals.

I will be conducting a number of financial analysis workshops over the coming months for property investors who are wanting support. If you would like me to do the same for you then please email me with your questions and I will call you at an appropriate time to discuss. I can be contacted on 0409279898.

Regards

Martin Josselyn

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PROPERTY INVESTMENT ANALYSIS (DESCRIPTIVE)

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Prepared for:	Mr & Mrs Investor
Consultant:	Martin Josselyn (Rule Three)
Property:	'Lindum Reserve' 73 New Lindum Road Wynnum West
Description:	Three Bedroom Townhouse

SUMMARY

Assumptions		**Projected results over**	**10 yrs**
Property value	$397,500	Property value	$711,862
Initial investment	$0	Equity	$298,204
Gross rental yield	5.36%	After-tax return /yr	69.05%
Net rental yield	3.51%	Net present value	$206,520
Cap. growth rate	6.00%	**IF SOLD**	
Inflation rate	4.00%	Selling costs	$20,783
Interest rate	5.05%	Equity	$277,421
Taxable income	$120,000	After-tax return /yr	67.77%

COMPUTER PROJECTIONS

Investment Analysis				**Projections over 10 years**		
End of year	2015	1yr	2yr	3yr	5yr	10yr
Property value	$397,500	421,350	446,631	473,429	531,945	711,862
Purchase costs	$14,338					
Investments	$0					
Loan amount	$413,658	413,658	413,658	413,658	413,658	413,658
Equity	$-16,157	7,693	32,974	59,771	118,287	**298,204**
Capital growth rate	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Inflation rate (CPI)	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Gross rent /week	$410	21,320	22,173	23,060	24,941	30,345
Cash deductions						
Interest (I/O)	5.05%	20,890	20,890	20,890	20,890	20,890
Rental expenses	34.56%	7,369	7,664	7,970	8,621	10,488
Pre-tax cash flow	$0	-6,939	-6,381	-5,800	-4,569	-1,033
Non-cash deductions						
Deprec.of building	2.50%	5,525	5,525	5,525	5,525	5,525
Deprec.of fittings	$25,500	3,535	3,419	2,779	1,916	864
Loan costs	$1,820	364	364	364	364	
Total deductions		37,683	37,862	37,528	37,315	37,767
Tax credit (joint)	$120,000	5,609	5,481	5,215	4,761	2,855
After-tax cash flow	$0	-1,330	-900	-585	192	1,822
Rate of return (IRR)	**69.05%**			**Your income /(cost) per week**		
Pre-tax equivalent	112.27%	**(26)**	**(17)**	**(11)**	**4**	**35**

Disclaimer: Note that the computer projections listed above simply illustrate the outcome calculated from the input values and the assumptions contained in the model. Hence the figures can be varied as required and are in no way intended to be a guarantee of future performance. Although the information is provided in good faith, it is also given on the basis that no person using the information, in whole or in part, shall have any claim against Martin Josselyn - t/a Rule Three, its servants, employees or consultants..

Detailed Notes on Spreadsheet Items

PROPERTY VALUE

The property (or market) value refers to how much the property is worth (i.e. how much you could sell it for). Its book value, on the other hand, refers to how much you have paid for it plus the cost of any immediate renovations.

Property price:	397,500
Renovation costs:	0
Total book value:	397,500
Property market value:	**$397,500**

PURCHASE COSTS

These include your solicitor's conveyancing fees and, where applicable, State Government stamp duty charges. In Australia, stamp duty varies from State to State and is a function of purchase price whereas, in New Zealand, it has been abolished on all property transfers since May 1999. Conveyancing costs may also be dependent on purchase price and may be negotiable. In some States of Australia (e.g. A.C.T.), purchase costs are tax deductible in the first year of the investment, though normally they will only be taken into account in Capital Gains Tax calculations in the year of sale.

Conveyancing costs:	2,000
Stamp duty:	12,338
Total Purchase costs:	**$14,338**

INVESTMENT & LOAN

Your initial investment is usually just the total of all monies outlayed at the time of purchase. These may include contributions toward any, or all, of the costs listed below. The remainder will largely determine the size of the loan. If you have sufficient equity in other property, it is possible to outlay nothing, and actually borrow the lot (i.e. the purchase price, purchase costs, loan costs, any renovation costs, and even additional monies to cover such things as fittings). If you are modelling an investment from some point in time after purchase (e.g. to assess the return on major renovations), your investment might also include the equity you already have built up in the property.

	Investments	**Loan**	**Total Cost**
Property costs:	0	397,500	397,500
Renovation costs:	0	0	0
Purchase costs:	0	14,338	14,338
Furniture costs:	0	0	0
Loan costs:	0	1,820	1,820
Totals:	**$0**	**$413,658**	**$413,658**

CAPITAL GROWTH & INFLATION RATES

Rate of capital growth is your anticipated annual compound rate of increase of the property value. It will undoubtedly vary substantially over the short term, but over the longer term (10 years or more), it has generally been about 2 to 3% above the rate of inflation.

Average rate of inflation (%):	4.00
Average rate of capital growth (%):	6.00

EQUITY

The equity is the difference between the property value and the loan. The equity increases in line with the increasing property value in the case of an interest-only loan. For a principal & interest loan, it also increases with the decrease in the debt.

Projected values over	**5 yrs**	**10 yrs**	**15 yrs**	**20 yrs**
Property value	531,945	711,862	952,632	1.275m
Loan	413,658	413,658	413,658	413,658
EQUITY	**$118,287**	**$298,204**	**$538,974**	**$861,179**
Approximate costs if sold......				
Solicitor's fees	532	712	953	1,275
Sales commission	15,123	20,071	26,692	35,553
EQUITY (after sale)	**$102,632**	**$277,421**	**$511,329**	**$824,351**

INTEREST COSTS & TYPE OF LOAN

The type of loan can be either interest-only and/or principal & interest. Repayments for interest-only loans, as the title suggests, consist of interest only. Repayments for principal & interest loans include a component of the principal. Interest-only loans are usually of a shorter term (e.g. 3 to 5 years) at which time they are usually rolled-over.

Loan type:	I/O Yrs 1-40
Interest rate (yr 1) (%)	5.05
Loan:	$413,658
Loan costs (written off over 5 yrs):	$1,820
Monthly payment:	$1,741
Annual payment:	**$20,890**

RENT

The potential annual rent is simply the rent per week times 52. The actual annual rent must account for any period that the property is vacant. Annual rents are assumed to increase in line with inflation.

Rent per week:	410
Potential annual rent:	21,320
Vacancy rate (%):	0.00
Actual annual rent:	**$21,320**

ANNUAL RENTAL EXPENSES

These are all the real operating costs associated with the investment property with the exception of loan interest payments. The first cell of the spreadsheet represents the expenses expressed as a percentage of the potential annual rent. As a guide, expenses could vary anywhere from 13% to 30%, depending on the maintenance and whether a professional property management agent is used. For holiday letting, with higher vacancies, the percentage can be more than 50%.

Normal Expenses:	
Agent's commission (8.25%):	1,759
Letting fees:	410
Rates:	1,600
Water:	800
Landlord Protection Ins:	500
Body corporate:	2,300
Special expenses:	0
Total expenses:	**$7,369**
Normal expenses as % of annual rent (%):	34.56
Net yield or Capitalisation rate (%):	3.51

PRE-TAX CASH FLOW

These are all of the monies that flow out of your pocket before tax is taken into account. Normally, it would represent the gross annual rent less interest and rental expenses. This will vary if interest or expenses are capitalised or rents used directly to reduce the loan.

Year		**1yr**	**2yr**	**3yr**	**5yr**	**10yr**
Rent		21,320	22,173	23,060	24,941	30,345
Cash invested	0	0	0	0	0	0
Principal payments		0	0	0	0	0
Interest		20,890	20,890	20,890	20,890	20,890
Expenses		7,369	7,664	7,970	8,621	10,488
Pre-tax cash flow	**$0**	**$-6,939**	**$-6,381**	**$-5,800**	**$-4,569**	**$-1,033**

DEPRECIATION ON THE BUILDING

This represents the capital allowance on the construction costs.

Property value:	$397,500
Construction costs:	$221,000
Depreciation allowance rate (%):	2.50
Depreciation allowance:	**$5,525**

DEPRECIATION OF FITTINGS (diminishing value method)

Item	Value	Effective Life (yrs)	Depreciation
General fittings	23,000	15.00	3,067
Low-value pool	2,500	4.00	469
Total	**$25,500**		**$3,535**

LOAN COSTS

In Australia, the loan costs are written off over the term of the loan (or five years, whichever is the lesser).

Establishment fees (0.24% of loan):	1,000
Valuation fees:	300
Registration of mortgage:	230
Registration of title:	115
Search fees:	175
Total loan costs:	**$1,820**

TOTAL TAX DEDUCTIONS (Cash & Non-Cash Deductions)

These include both "cash" (e.g. interest, rental expenses) and "non-cash" (e.g. depreciation) deductions.

Year	1yr	2yr	3yr	5yr	10yr
Interest	20,890	20,890	20,890	20,890	20,890
Expenses	7,369	7,664	7,970	8,621	10,488
Deprec.-building	5,525	5,525	5,525	5,525	5,525
Deprec.-fittings	3,535	3,419	2,779	1,916	864
Loan costs	364	364	364	364	0
Total deductions	**$37,683**	**$37,862**	**$37,528**	**$37,315**	**$37,767**

TAX CREDITS & AFTER-TAX CASH FLOW

The after-tax cash flows are all of the monies that flow in or out of your pocket AFTER tax is taken into account. They represent the PRE-tax cash flow LESS any tax credits (or tax refunds). In this analysis, it is assumed that the investor has obtained a tax variation from the Taxation Office and thus the tax refunds are credited for the same year in which they are based.

Year	2015	1yr	2yr	3yr	5yr	10yr
Pre-tax cash flow	0	-6,939	-6,381	-5,800	-4,569	-1,033
Tax credits		5,609	5,481	5,215	4,761	2,855
After-tax cash	0	-1,330	-900	-585	192	1,822
Income /(cost) per week		**(26)**	**(17)**	**(11)**	**4**	**35**

INTERNAL RATE OF RETURN

The internal rate of return (IRR) is the method of calculating the return on a series of cash flows where the time factor is taken into account. To understand it, think of the money you are outlaying on your investment property as being deposited in a bank account, with interest added each year. In this case the "deposits" are represented by the after-tax cash flows

Year	2015	1yr	2yr	3yr	5yr	10yr
After-tax cash flow	$0	$-1,330	$-900	$-585	$192	$1,822
Equity						$298,204

The total amount in your "account" (including interest) at the end of the period is the equity ($298,204) in the investment property. The IRR (69.05%) represents the effective "interest rate" that you have received, but with one important difference - because the interest remains in the property, it is not taxed. To receive an equivalent return from bank interest, you need to get 112.27% before tax.

If the property were to be sold at the end of the period, the after-sale equity would be reduced to $277,421 after taking account of selling costs and the IRR after the sale would be 67.77%.

TAX BENEFITS

These are shown below for the given taxable incomes and are based on the specified tax scale.

Number of properties: 1

	Investor	Partner	Total
Ownership: joint names	99.00%	1.00%	100%
Current taxable income:	80,000	40,000	120,000
Rental income:	21,107	213	21,320
Total income:	101,107	40,213	141,320
Rental deductions:	37,306	377	37,683
New taxable income:	63,801	39,836	103,637
Current tax:	18,747	4,747	23,494
New tax:	13,196	4,689	17,885
Tax savings:	**$5,551**	**$58**	**$5,609**

INVESTMENT CAPACITY

Buying 1 such properties (registered in joint names), and taking into account current net incomes and expenses as shown, the difference between total income and total committed expenses in the first year would be $95,176. Total initial outlay would be $0.

Number of Properties: 1		Registered: joint names
Ownership:	Investor (99.00%)	Partner (1.00%)

Income

Current net income	
Current assessable income (Investor):	80,000
Current assessable income (Partner):	40,000
Total net income:	120,000
New rental income:	21,320
Total income:	**$141,320**

Expenses

New tax (Investor):	13,196
New tax (Partner):	4,689
Rental expenses:	7,369
Investment loan expenses:	20,890
Total expenses:	**$46,144**
Net surplus (first year of investment):	**$95,176**
Total initial outlay required:	$0