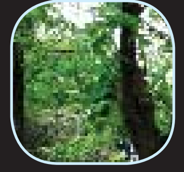
Home Study Program Module 10
Property Strategies

Wealth Creation Dynamics

Learn how to **drastically** advance **your** financial future.

by Philip Sigglekow

Author of best seller 101 ways to get rich quicker.



Welcome

Module 10
Property Strategies

Welcome to module 10 of the Wealth Creation Home Dynamics Study Course - Property Strategies

This module is number 10 of 24.

Each module is presented in the same layout and contains exercises that you can do in your own time.

The benefits of participating in this Home Study Course are:-

- You progress at your own pace.
- You can study in the privacy of your own home.
- You can ask questions regarding the course at questions@apin.com.au

We hope you enjoy the Wealth Creation Home Study Course.

Best regards,
The team at APIN

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Understanding the Basics

If you read the rags to riches stories of many Australian millionaires, it is amazing how many of them derived the bulk of their wealth from property investments. Some have remained in property while for others the profit they made from property has given them the financial backing to branch out into other areas.

It's is not all that surprising that many of today's millionaires first made their fortune in property. Property and the sharemarket are the two main investments which offer the prospect of significant capital growth. Moreover, in some years this growth can be spectacular.

But — just like the sharemarket — if you buy property at the wrong time you could lose a substantial amount of money.

One reason for this is the "negative gearing" effect on property investments. Normally investors do not buy property outright. Typically they use some of their own money, usually between 10 per cent and 25 per cent of the property's price, and borrow the rest. If interest rates go up and property prices and rents remain static they can find it difficult to meet the repayments on the loan. They might then be forced to sell the property in a falling market.

One of the attractive things about property investment is that it doesn't take too long to become an expert. Basically, you do your own market research by reading the papers, inspecting properties, comparing values and determining how much you will receive in rent.

As with any type of investment, success comes from good management rather than good luck. With property it is essential to thoroughly research the market. The first place to start is probably in your local area since you have knowledge of prices and rents and can keep an eye on the property more easily after you buy it.

Different types of property investors — which one are you?

Basically, there are three types of people who invest in residential property: owner-occupiers, long-term investors and speculators. The motives that drive these three groups are quite different and need to be understood to get a clear picture of what forces drive the property market.

Owner-occupiers are influenced mainly by the interest rate on home loans, the current state of the economy — particularly the level of unemployment — and the relative costs of renting versus home mortgage payments.

Long-term property investors are attracted to the market when the returns they get from rent and potential capital gains are comparable to returns available from other investments, such as fixed-interest securities and the sharemarket.

Speculators generally become involved in the property market midway through the upturn in anticipation of future price rises. Frequently the sheer volume of money pushes prices higher, thereby fulfilling the speculators' hopes. Eventually prices are driven up so much the yield on property becomes unattractive in comparison with other types of investment and speculators move on to other investment areas. When speculators leave the market there is a sharp fall in activity and often a major short-term drop in prices.

So there are three main things to keen an eye on if you are thinking about buying property as an investment.

Firstly, are interest rates likely to go up or down? If rates are going up it means other forms of investment, such as fixed-interest, become more attractive and the cost of buying property increases. Both are likely to have a depressing impact on prices.

Government policies can affect the property market

Government tax policies have a major impact on long-term investors. For example when the government introduced restrictive conditions on negative gearing in 1985, property became much less attractive. When these restrictions were lifted in 1987, it had the reverse effect.

Secondly, is the government actively encouraging property investment either by favourable tax breaks for property investors or assistance for home buyers such as a First Home Buyers' Scheme? What the government is doing by such policies is adding to property demand. As it takes time to add to the supply of houses by building new ones the initial impact of these schemes is to send prices higher.

Thirdly, are speculators moving into the market? There is no single way of establishing this. One way is to read the real estate sections of major daily papers since there are often comments from people in the industry either bemoaning or rejoicing in the presence or absence of speculators.

If there seems to be a lot of speculative activity, this is a sign the market might be becoming overheated and the risks of property investment are increasing.

All prices are negotiable

The price a vendor, i.e. the seller of a property initially asks is usually higher than the price they would be willing to accept. You should consider the price they are asking as the maximum price you would have to pay for the property. Generally, sellers expect buyers will offer them a lower price than the one they are asking. It's then up to both parties to negotiate on the actual price.

Where to get information

Unlike the sharemarket there is not a national property market where the prices of different properties are traded. Indeed, if you live in Brisbane and are thinking of buying property in Brisbane, you do not need detailed knowledge on what is happening to property prices in Perth.

Most local "giveaway" newspapers have information on the results of auctions in the local area, as well as pages of advertisements listing properties and their asking prices.
The property sections of major daily newspapers also have considerable information on residential property. If you are interested in non-residential property your best sources of information are the property section of The Australian Financial Review and Australian Property News. The Real Estate Institute (REI) in your capital city is also worth approaching.

It is imperative you keep abreast of developments in the property market and factors that affect the market such as inflation and interest rates.

Property Jargon Explained

- **Body Corporate:** All the owners of units or apartments in a strata building. These owners elect a council which handles administration of the building.
- **Bridging finance:** Short-term finance used while you wait for your existing property to sell.
- Caveat: Warning to any purchaser that a third party has some right or interest in the property.
- **Contract of sale:** A legal document prepared by the seller's solicitor or agent. It describes the property, price, seller, buyer and conditions of transaction. It is legally binding when signed by both buyer and seller and after a deposit has been paid.
- **Conveyance:** The transfer of ownership of property from seller to buyer.
- **Covenant:** Terms, conditions and restrictions noted a property's certificate of title. The covenant may affect future development plans or resale.
- **Easement:** A right over your own or another person's property to use or prevent the use of the property in a particular way.
- **Encroachment:** Use of part of an adjoining property without consent – usually a structure overhanging onto the street or onto a neighbour's land.
- **Encumbrance:** An obstruction to the use or transfer of the property in the form of a right or interest in the property, e.g. Easement, mortgage or caveat.
- **Fixtures:** Built-in items actually fixed in position, e.g. Kitchen cupboards, linen or storage cupboards.
- **Gazumping:** Where the seller agrees to sell to a particular buyer and then either sells to another buyer or raises the price if two or more buyers bid for the property.

- **Holding deposit:** Refundable amount paid to the real estate agent when you decide to purchase a property. It is an indication of goodwill and does not oblige you to proceed with the purchase.
- **Memorandum of transfer:** A document that verifies the change in ownership from seller to buyer.
- **Passed in:** When a property is withdrawn from sale at auction because the bids do not reach the reserve price it is said to be passed in.
- **Settlement:** Completion of a conveyance where the balance of the contract price is paid and ownership of the property passes from seller to buyer.
- **Stamp duty:** State tax paid by the property purchaser, calculated as percentage of the sale price of a property.
- **Survey:** Identifies the boundaries of the land and improvements to be transferred and confirms that you are actually buying the property you have chosen.
- **Tenants in common:** Two or more purchasers owning a property in equal or unequal shares. If one dies, his/her shares pass to the beneficiaries under his/her will.
- **Unencumbered:** A property free of encumbrances, covenants and restrictions.
- **Valuation:** A report by a registered valuer giving their opinion of the value of the property.
- **Vendor:** The seller of the property.
- **Zoning:** Sets out the allowable uses of a property permitted by planning authorities and local councils.

The real estate cycle

Talking to real estate agents will probably give you the impression that house prices never fall and therefore you cannot lose on property investments. Unfortunately, this is not always correct. Certainly over the long term house prices have risen faster than inflation. But there are many periods where house prices have fallen in absolute terms and others where they have not kept pace with inflation.

Prices can be going up in one suburb and going down in another.

What tends to happen is that rather than rising steadily every year, house prices flatten out for a number of years before jumping by 80 per cent or more in 12 to 18 months. After this rapid rise, house prices may fall in absolute terms and then not keep pace with inflation for several years. Obviously, if you buy at the peak of any boom the return on your investment will not be as large as someone who bought in near the bottom of the cycle.

Nevertheless, the property market is less volatile than the sharemarket. The principal reasons for this are that property takes time to sell, there are significant fees in both buying and selling, and there are different expectations in the property market.

Property is less volatile than shares

Investors are more inclined to hold on to their property assets even if prices are going down. In contrast, shares can be bought and sold every day and if there is a general belief that share prices will fall, buyers start bailing out quickly — which make the decline worse.

If you invest in property you should view it as long term, i.e. at least a four to five-year investment. In contrast, sharemarket speculators might buy and sell shares in the same week. Speculators in the property market would be looking at holding their property for at least six months — unless prices rose significantly.

Decision Time

Determine your budget

Before you begin to look at properties you need to determine how much you can afford to borrow — and how much a lender would be prepared to lend you. When you approach a lender you need to take with you evidence of your income and savings, the budget you have prepared and a statement of your assets and existing debts. Unless you do this you might waste considerable time looking at properties outside your price range.

Most home lenders have personal budget planners that are available free of charge.

The only way to ensure you are not getting in over your head is to do a careful budget. It is a good idea not to cut things too fine. Set aside some money for emergencies. Be conservative — do not rely on future wage rises to help you pay off the loan.

Also, if you are taking out a loan with a variable interest rate you should calculate how you would manage if the interest rate on the loan rose by one or two percent age points.

Real estate agents will have given you a general price range that they think the property will reach. Don't take too much notice of this because it is generally on the low side. Agents do this to encourage more people to turn up to the auction — on the premise that the higher the expected price, the fewer the potential bidders.

If you are interested in a property that is to be auctioned you need to obtain relevant information from the real estate agent, such as a copy of the contract, price range and, where possible, the reason the property is being sold.

This last factor in some cases may give you the chance to make an offer that may suit the vendor. For example the vendor may have bought elsewhere. It may be wise to make a reasonable offer and provide them a 20 per cent deposit, rather than 10 per cent, which they can immediately release. Be prepared to tailor the offer if necessary.

Making an offer before auction however has its dangers. You are signalling to the agent that you have at least that amount of money so they would expect the offer to be bettered at auction if it is not accepted originally.

Often when you select a property the auction does not take place for several weeks. Many people set their mind on a property and look no further. Don't do this because generally the price you have been quoted is lower than is expected. In many cases bidding may start at the price you are expecting to buy at. Also it is better to look around as it will confirm the value of the property you are looking for.

Remember auctions can be exciting and fun, but not if you have overpaid. Selling at auction is a much better option where others must vie for your property.

Deciding on a property

One of the most common questions inexperienced property investors ask is "which property should I buy'?" It seems like such a simple question and yet so many people have difficulty in choosing the right property. What often makes it difficult is that people want to combine their home and investment ambitions. If you want to select a home to live in, then choose a property in a reasonable position with all the amenities you require.

Most people also want to buy a home with the best investment potential. This is where a little foresight is required. On a strategic level, you need to analyse the area, its values, its growth potential and its geographic location — particularly in relation to the Central Business District or a major commercial centre.

Secondly, is the property situated close to public transport facilities such as bus, train and taxi services? Thirdly, the zoning of the area is most important. It can greatly increase the value of property and at other times it can cause serious financial hardship for the property owner.

When you have completed an analysis of these three issues and selected a property, you must then study its specific location. A classic statement in real estate is that it is better to own the worst house in the best street than to own the best house in the worst street.

You should look for the following characteristics wherever possible:

- Is the property on the high side of the street? From a day- to-day perspective this makes little difference. But the reality is that properties tend to sell much quicker when in a higher position.

- Is the property in a corner location? With the advent of dual occupancy, corner blocks have become more valuable. In areas where such developments are occurring, corner blocks are achieving higher prices. If you cannot decide between two homes, and one is on a corner, this issue may be worth considering. If you currently live on a corner and are planning to sell, do some homework. Check whether a dual occupancy development is a possibility.

- Does the property have adequate frontage? If you are looking in an area where many new homes are being built and you are purchasing an older home, ensure the frontage is adequate for building at a later point. Frontage should be a minimum of 15.24 metres or 50 feet. This minimum width will add value when you sell.

- Does the property have views? Over the past ten years the prices for properties with water views have soared — mainly because they are in limited supply. Properties with views of the bush or picturesque city scenes are also becoming more highly regarded.

It is important to distinguish between repairs and renovations for tax purposes.

Keep detailed records

Under the new self assessment income tax system it is imperative you keep detailed records of every expense so tax deductions can be made. In addition, you must know exactly when you bought the property as any capital gains you make can be adjusted for inflation.

Another thing to be aware of is repairs and maintenance are tax deductions but renovations are not. Far example, if you replace the kitchen or bathroom, this is seen as a renovation and the cost is not deductible from your rental income. However, if the stove breaks down and is replaced, this is a repair and is deductible.

- Does the property have a high rental return? If the property you wish to purchase is well located it will be reflected in its rental return. Although you may never intend to rent the property you can be more confident about capital gain.

Ultimately the best property investments are those that appeal to the largest market. Do not make the mistake of buying an investment property that appeals to a small or limited part of the market.

First-time investors

If you buy a good property in a good street you rarely go wrong. Remember to buy where people live, rather than where they might like to live. This means that residential areas with a full range of services are usually a better proposition than tourist resorts.

If you are a first-time property investor, go for a good clean property than you can sell in both an up and down market. Properties in a poor state of repair can be sold in a boom market, but are almost unsalable in a down market. Before buying, check the zoning to make sure it is suitable for the purpose you have in mind. In addition, other developments planned for the area may affect the value of the property. A trip to the local council is essential to check on these details.

After you have taken the plunge and bought the property, you cannot forget about it. As with any investment, it needs constant monitoring. If you are letting a house you should inspect it at least every three to six months. One large property investor doesn't allow tenants to pay their rent by mail; he goes round to collect it every month. This is a good policy but not everyone can do it.

Exercise

Prepare a budget to work out how much you could afford to borrow to buy your first home or an investment property. By adding the amount of deposit you can put up you can estimate the price range of properties you can afford.

Approach several home lenders and establish how much they are willing to lend you and on what terms. Don't forget to take into account costs such as application fees, stamp duty and solicitor's fees.

Location

There are four basic principles you should follow for successful property investment: location, quality of improvements, tenants and timing.

There is an old saying that successful property investment depends on “location, location, location”. Certainly location is an important ingredient, because poorly located property will almost inevitably lose value in tough economic times.

It is also harder to attract tenants and more difficult to sell when the overall property market is flat. Remember that what makes a property cheap to buy will also make it cheap when you come to sell. You should always purchase the best possible location you can afford — whether it is a place you are going to live in, or rent out.

What makes a property well located? There are several factors which must be considered: convenience to public transport and other services such as schools and shops; the socioeconomic standing of the suburb; and proximity to the city.

If you are buying an investment property is there a big demand for rental accommodation in the area? Are there large factories, hospitals or universities?

Finally, location can mean whether you should stick to your local area or buy in another part of Australia. Generally unless you have extensive knowledge of interstate property markets, or can travel regularly to inspect your investment, you should buy property close to where you live.

You can’t improve the location

Remember location is the one feature of a property that usually cannot be changed or improved upon. If the property is on a busy street or opposite the railway station it will always sell for less than a similar property in a quieter area. Of course if you think or know the road is about to be closed to traffic, or the railway line is going to be diverted, this would certainly enhance the attractiveness of the property and lead to a rise in its market value.

Always check the condition of the property with a property inspection.

Quality of Improvements

Many investors make the mistake of over-capitalising property — whether it is their own home or an investment property. Essentially, this means spending too much on improvements and renovations. For example, it could mean spending $50,000 putting in a top-of-the-range kitchen and bathroom which might only add $25,000 to the price of the house.

Don't forget what you usually buy with property is a house and land. Normally it is the land value that appreciates quicker because it is in limited supply. The value of the actual house rises more in line with the cost of replacing it — i.e. the cost of building a new house.

Therefore putting in expensive kitchens or bathrooms is fine if you are going to live in the house for some years and get the benefit from them. But don't expect to get a short-term gain by carrying out extensive improvements on your house. In most cases you will be lucky to break even in the short term, although it may mean the property is easier to sell.

Don't rush into extensions before living in the house for at least six months.

Improvements should be of a general-purpose nature, such as painting and re-carpeting. But they shouldn't be cheap and nasty — use reasonable quality materials; shoddy renovations will only turn off potential buyers. Renovations should not be too trendy or specialised. All this will do is reduce the number of potential buyers.

Disadvantages of property investment

The main disadvantage of property investment is that it is not liquid. Generally you can allow at least three months from the time you decide to sell until the time you get your money. In addition if you sell it is an all or nothing decision. If you own a property worth $200 000 you cannot sell $20,000 of it.

The other potential problem is you have all of your property investment eggs in one basket. If you buy a problem property or are unlucky enough to get destructive tenants you could lose a substantial amount of money.

Tenants

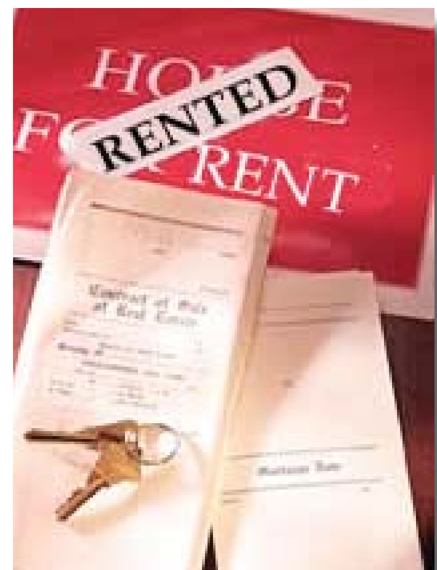
Many investors make the mistake of over-capitalising property — whether it is their own home or an The biggest headache for any landlord is tenants. A good tenant, i.e. someone who pays the rent on time and doesn't do any damage to the property, can significantly increase the return on your investment. Alternatively, a poor tenant can be a real pain in your bank balance.

Most property investors get a real estate agent to manage their property. This has the dual benefit of avoiding emotional involvement with any of the tenants' problems and puts the property in the hands of someone who should know when to raise the rent and by how much. Of course, some agents are better managers than others, so keep an eye on both the property itself and the rental market in general.

Try to anticipate future developments

To become a serious property investor, rather than a dabbler, you have to anticipate future developments in the market. For example, anyone who bought inner city property, anticipating high earners would return to these areas from the outer suburbs, would have made a killing.

Suburbs tend to go in steps. Generally you will get a higher capital gain if you buy in areas which are just beginning to be regenerated rather than in ones where this has already happened.



Timing

Residential prices can fall in absolute terms and frequently decline in real terms. If you buy property at the peak of a boom it could be several years before you come out in front. As with sharemarket investments, timing is the hardest thing to get right. Even so it makes an enormous difference to your overall investment returns.

Be wary of buying in a boom market.

As a general rule you should be wary of buying when everyone else is buying. This is a sure sign the market is closer to its peak than its trough. As the property cycle usually moves more slowly than sharemarket cycles you should look at property as tying your money up for at least three to five years, and more probably seven to eight years.

When is the best time to buy?

Property definitely goes in cycles. In a boom market values don't seem to count. Properties that you think would sell for $100,000 go for $150,000. Buy in a down market taking a five-year view and nine times out of ten you will win. The main trouble with this is having the money to invest when things are tight. In the long term you will be more successful buying the worst house in the best street than buying the best house in the worst street. This could also be extended to buying a weatherboard house in a suburb where most of the houses are brick.

Another piece of advice is to buy your home with you heart and an investment property with your head. If you intend living in a particular property, it is better to pay too much and be happy than to buy a bargain and hate living in it.

In a boom, agents are reluctant to negotiate to lower their commission as there would be plenty of sellers happy to pay the full rate.

WHAT ARE SOME OF THE TRAPS

It really depends on the type of property you buy. If you are buying a shop or motel you have to be careful that the current owner is giving you the correct turnover figures. If you are buying property in a holiday resort remember you might get $1,000 per week rent in the high season, but the property might be empty for nine months of the year.

With industrial property the big danger is that a factory or warehouse could be vacant for anything between six months and two years in a severe recession. In contrast, although the costs of maintenance for residential property are higher than for industrial properties, vacancies are usually much less.

Once you become more familiar with property you might try something more innovative and adventurous. You might see the potential of buying a house on land large enough for two houses. By sub-dividing the land, moving the existing house onto one block and selling off the other, you can make big money. All the same these schemes are more for people who are experienced in the property market rather than for amateurs.

Exercise

Do your own research

Check council records for previous sales of similar houses in the area. Also many local newspapers, as well as The Age and The Sydney Morning Herald, publish auction results. From this research, decide what you are prepared to pay for an investment property.

Auction Basics

How to be a winner in the property auction market

If you are thinking of investing in residential property, you'll need to get used to bidding at auctions. Like it or not, the probability of having to buy your next property at auction is increasing. Successful bidding at property auctions involves planning ahead — establishing what type of property you want, understanding the current market, and knowing when to stop bidding. If you are interested in a property you need to get a copy of the property contract from the real estate agent and have it examined by your solicitor or conveyancing company.

Don't be pressured into bidding money you do not have

Pay particular attention to special conditions such as penalty interest for late completion of the contract. Check the settlement period — i.e. when you have to make final payment for the property. If the time frame doesn't suit you, try to arrange a change through the agent before the auction. Make sure it is put in writing. Changing the settlement period can be arranged on auction day — but you will be in a better bargaining position if it is negotiated beforehand.

Try to control your emotions. Many problems arise when buying at auctions. You should take care not to let your emotions take over. There are many celebrated cases where the excitement of the moment coupled with competitive spirit resulted in paying many thousands over budget.

How property auctions are run

The auctioneer will outline the basics, of the contract and then call for an opening bid. Agents are entitled to make one bid at the auction, but often the vendor, the seller, will arrange for a friend to make bogus bids even though this is not allowed by law. An auctioned property is sold to the highest bidder provided the reserve price has been reached.

The seller sets the reserve price, and often the exact figure is not known by the agent until just before the auction. If the bidding stops before the reserve price is reached the agent usually seeks advice from the seller. The agent will normally attempt to convince the vendor to lower the reserve.

There are three possible outcomes:

1. The seller won't change the reserve price, the auction stops, and the highest bidder has first right to negotiate on the property.

2. The auctioneer announces the bids are close to the reserve and encourages further bidding.

3. The auctioneer lets it be known the property is "on the market". This means the reserve price has been lowered to the current highest bid. If there are no further bids, the property will be sold to that buyer.

False bidding may take place at an auction without you knowing. The way an auction operates lends itself to such scenarios. Keep your wits about you.

Tactics for buying property at an auction

Don't let the agent know you are keen on the property — unless of course you are so keen you wish to make an offer before the auction. Some people like to bid from the start. Generally this is not wise. It lets the agent and the auctioneer know you are a keen bidder. As the auction draws to a close other bidders will believe you are running out of money, and will be more willing to bid against you.

A useful tactic is to wait for the bidding to near your price limit and then bid for the first time. Make the jump in the bid a big one. For example, suppose your limit is $300,000, the bidding reaches $280,000, and is going up in $2,000 lots. Make a bid of $285,000 or $290,000. This often psyches out other buyers by giving the impression you have plenty to spend. If the bidding exceeds $300,000, you will lose the property anyway.

Look as calm and clinical as possible. If you think you will get carried away and bid above your predetermined limit ask someone else, a friend or a property adviser to bid for you.

Agents & Auctioneers

Choosing an agent when selling at auction

If you are selling property at an auction choosing the best agent is critical to the auction's success — so check their profile in your local area. At the initial meeting get the agent to outline their fees, the type of auction campaign they will run and when the property will be open for inspection. A minimum advertising campaign of four weeks is advisable, but six weeks is better. At this stage do not discuss the reserve price. Ask the agents for their opinion; don't give yours. At this point they will usually inflate the property's value.

There is no "cooling-off" period with auctions

Be aware that if you are the highest bidder in an auction and the bid is above or equal to the reserve price, the property is yours. If you are the successful bidder, you must sign the contract and pay 10 per cent of the auction price immediately – unless you have made other arrangements with the seller. This 10 per cent is non-refundable. There are no "cooling-off" periods for property auctions. If you cannot come up with the remaining 90 per cent of the price, you can lose your 10 per cent deposit.

Try to remember this if you are tempted to make a bid above your predetermined limit. Don't fall for the old trick when the auctioneer or agent says "it's only another $2,000". If you don't have it, don't bid it.

Get the agent to discuss their version of the positive points of the property, outline their sales pitch to potential buyers and advise what price bracket they will quote them. Usually they quote the lower end of the price range to buyers in order to get more people in. Before signing an agency agreement ask to be shown their advertising campaigns for similar properties.

Once you agree to auction with a particular agent get them to send you a copy of everything they include in their advertising campaign. Also insist they call you at least once a week to keep you informed of progress. Make sure the ads highlight the attractiveness of the property — not the agent's name.

If your property goes to auction and doesn't sell, agents usually want sole licence to sell it for a month after the auction. It is best to keep them on their toes by limiting this to one or two weeks. Make sure this is included in the original agreement.

Selecting an agent

- If one agent has a substantially higher fee than all the others you interviewed ask them to demonstrate how paying a higher fee will benefit you.

- One of the pitfalls in a flat or falling market is that real estate agents may tend to over-appraise your property to get you to list with them. Once you have signed a contract the agent may then try to talk you around to putting a more realistic price on the property. For the agent the important thing is to get the listing. So once your property is listed with an agent you need to ensure the agent continues to focus on getting the best price for your property.

- Never choose an agent simply because they promised to get the highest price for your property. They might not be able to deliver on this promise.

- Before choosing an agent attend a few auctions to asses their professionalism.

- Agents should be able to justify their recommended method of sale – either auction or private treaty – on the basis of results and market research.

- Ask for a written proposal. Choose an agent on the basis of their proposed marketing plan, how clearly they have identified their costs, whether their price estimates for the property are realistic, and their ability and willingness to report regularly on inquiries. Get the agent to put all this in writing – an agent's written submission reveals much about their attention to detail and professional approach.

- Finally, you need to be confident you can trust them to put your best interests first. If necessary remind them you – not the buyer – are the one paying them commission.

How to get the best price when selling at auction

Just as inexperienced buyers at property auctions can end up paying too much, unwary sellers at auctions often receive less than their property is worth. Unless you make a living out of buying and selling property you will probably only sell property at auction two or three times in your life. So it's essential to make the best of each of these occasions.

One decision you need to make is whether to have your property open for inspection or viewed by appointment only. Being open for inspection is usually preferable. You will get people just looking but you will get more people viewing your property. Also "by appointment" gives the impression the property is expensive and people deciding on whether or not to look probably won't be bothered.

Don't forget to ask where the auction will take place. The best spots are in the agent's rooms or on site. Don't auction at the local town hall — the surroundings are usually not conducive to exciting bidding.

It is much better to have the auction on site so buyers can feel the property's atmosphere. Opening your property for inspection on a Saturday, early to late afternoon, is the best time. Opening on a Wednesday is not normally worthwhile. The agent should have an "Open for Inspection" sign on the property and/or a sandwich board on the street. If someone makes an offer don't look too excited. In particular, do not reveal your asking price unless, of course, the buyer is close to the price you want.

On the auction day make sure the house is clean and the lawns are cut. Normally buyers are allowed to inspect the property for half an hour before the auction. Just before the auction give your reserve price to the agent in a sealed envelope.

Should you accept offers before auction?

On the positive side, you may sell the property without the stress of an auction. It is possible that several buyers may engage in a bidding duel. The disadvantage is if the buyers make reasonable offers and feel they are close to your required price, they are less likely to go past that figure on auction day. Essentially you are revealing your hand to the agent and buyers.

Private Sales

The alternative to selling at auction is to sell via "private treaty". You can do this yourself or through an agent. With private treaty individual buyers inspect your house and decide whether they are interested in making an offer for the property. You are then free to either accept or reject the offer.

If you make an offer under a private treaty arrangement and the agent considers the offer to be too low, you can insist they communicate your offer to the seller.

You may be asked to put your offer in writing in the form of a contract note. If you make an offer in this way and the seller accepts it, a binding contract may come into existence at the time the seller signs the contract note. So be certain you want to buy the property before signing a contract note.

How to set your reserve price

Set a reserve price a little higher than you require. Remember if the bidding reaches your reserve price you are committed to sell. You can reduce the reserve price during the auction when the bids are getting close. Unless you are happy with the current price, don't drop it to the current bid. If the agent is encouraging you to drop your reserve price ask them to lower their commission. If you agree to sell your property the settlement period is usually around six to eight weeks. You can ask for immediate release of the 10 per cent deposit put up by the buyer. It can be used to buy another property, or be put in the bank to earn interest.

In a flat market, many properties are "passed in" without one bid being made.

The rights of the parties to an auction

Many people are not aware of the rights of the various parties at a property auction. There's nothing quite like auction day – a healthy tension is in the air with buyers wanting to pay very little and vendors hoping for multiples above the reserve price In the middle, of course, there's the auctioneer who wields great power during the auction.

Are auctions the best way to buy

One of the most common questions asked by people buying property is 'should I buy at auctions. In reality the answer quite often is you have no choice. Auctions today are definitely part of our everyday life. Agents prefer them because they have the buyer and the vendor together in an electric atmosphere where almost anything can happen. If you can avoid an auction as a buyer you are often better off.

Although an auction can be over in as little as five minutes a great deal of preparation goes into the planning phase. The vendor must ensure they have selected the best agent and this task alone can be painstaking. Vendors should look for agents with strong marketing campaigns, negotiable commissions and a good reputation for honest dealing.

The vendor should also ensure the agent is, at all times, providing feedback as to the market reaction to their property. Once the agent has been selected you must provide them with a contract outlining the minimum amount of information as required by law. Also, you must tell the agent the reserve price at or before the auction.

If you are the seller your responsibility does not end at the auction. On settlement of the property you must pay the agent the agreed commission. Generally, this is somewhere between one and three per cent of the sale price. The amount of commission often depends on your ability to negotiate – and how keen the agent is to have your property on their books.

Potential buyers also have responsibilities beginning before the auction. They should have had the contract examined, studied property values in the area and organised finance.

The most important issue for buyers at an auction is to understand that if the reserve price has been reached, the highest bidder above reserve will have to buy the property when the hammer falls.

The buyer must pay the deposit, usually 10 per cent of purchase price, and sign the contract. The vendor or agent, as their representative, signs a duplicate copy. It is important to note that if contracts are exchanged at the auction, a cooling off period does not apply.

If your agent does the wrong thing

Real estate agents also have responsibilities to their clients. The Real Estate Institute in each state has a code of ethics to be followed by all its members. The code provides that relationships with clients must always be confidential. Agents have a clear duty to protect the public against fraud, misrepresentation and unethical practices.

Complaints about the behaviour of real estate agents can be made to the Real Estate Institute and complaints about the behaviour of auctioneers can be made to the Real Estate Services Council.

Typical clauses in property contracts

Although there are "standard" contracts for buying and selling property you can ask for other conditions to be incorporated in the contract. And it is up to the other party to say yes or no. The most important things for you to consider when negotiating the contract, apart from the price, are:

- Settlement date: This is the day on which the purchase price is paid and you take possession of the property. Make sure you set a reasonable data and take into account the time you need to arrange finance, and how much notice you have to give if you are leaving a rented property. If you are selling a property and buying another one, try to coordinate both settlement dates for as to avoid having to pay for bridging finance.

- Chattels: What furnishings are included as part of the property? Unless an item of furniture is specified in the contract as being part of the settlement, the seller is allowed to remove it at or before settlement. Although hot water services, stores and built-in ward robes are regarded as being automatically included in a contract because they are "fixtures", it is wise to list everything you expect to buy as part of the property.

- Special conditions: These special conditions cannot be inserted into an auction contract after a successful bid – unless the seller agrees – but they can be the subject of negotiation before the auction.

- Conditional on a loan: Unless you are certain you have all the funds you need to buy the house, any contract you sign should be conditional upon you obtaining a loan.

- Conditional on the sale of an existing property: Where the purchase of one property is conditional on selling another.

- Conditional on a building inspection: This gives you the chance of further negotiation if faults are discovered.

- Other conditions: You can cover almost any situation in a contract of sale. For example, you could require the seller to complete specified repairs.

The role of the auctioneer

Another major party to an auction is the auctioneer who is normally the principal or representative of the real estate agent. The auctioneer is the sole arbitrator – his or her decision is final. There have been many cases where disputes have arisen. For example, suppose a person bids before the hammer falls for the third time. A protest develops as the auctioneer claimed not to have heard the bid. But as he is the sole arbitrator he can declare the auction over.

In other cases auctioneers have not accepted a bid because they deemed the bid was not in the interests of the vendor. This may happen when a person arrives late to an auction and is unknown to the agent.

How auctions begin and end

Typically the auction starts by the agent giving a general price range which he or she thinks the property will reach. The auctioneer will highlight the basics of the contract and then call for an opening bid. Agents are entitled to make one bid at the auction.

Normally the agent will infer the reserve price has been reached by saying things like “I can sell” or ‘the property’s on the market”.

Exercise

Attend some property auctions in your local area to get the feel for how auctions operate. Take note of the prices achieved and which particular features of the properties are highly regarded.

Finance Basics

Take time to seek out the best financing package

As an investor you should spend a great deal of time on the financing aspect of any property purchase. Once the property has been chosen, the total cost must be determined. It will include many costs, such as the purchase price and the stamp duty on purchase — which is a major cost. Often people borrow that amount as well.

There are also legal and search fees, lender's legal fees, house insurance, registration of the title in your name, adjustments on rates, removalist's fees and survey fees. If, after adding up the costs of these, you are still courageous enough to want to buy, it is now time to approach several lending institutions. Often if the property is being auctioned there is no time to get formal approval of finance. If this is the case you should try to discuss approval in principle with lending institutions before the auction.

Banks will normally lend up to 75 per cent of their valuation of the property. Building societies and credit unions generally tend to lend up to 80 per cent of their valuation of the property. Depending on your ability to repay the loan you may be able to borrow up to 95 per cent of the lender's valuation of the property if you take out mortgage protection insurance. Loans are normally to be repaid over a period of 15 to 25 years.

Mortgage insurance protects the lender for a loss where the property is sold following the default of the borrower. It does not protect the borrower.

As a temporary measure, if you can't get housing finance from a traditional home lender you could consider a fixed-term loan. This type of loan is commonly made by private lenders, often made through the offices of a solicitor.

The lender's valuation of the property

Be prepared for the lender to value your intended property purchase at less than the price you have negotiated to pay for it. For example, suppose you have negotiated to buy a property for $100,000. The lender might value the property at $90,000 and then be prepared to lend you 80 per cent of their valuation — i.e. $72,000. So instead of having to invest $20,000 of your own money, you will have to put up $28,000.

The most favoured feature of this type of loan is that the borrower will usually pay only interest on the principal sum, making no reduction in the principal sum itself. With a fixed term loan the lender can demand the whole of the principal sum at the end of the term.

So you need to have alternative sources of finance lined up just in case. If you take out a fixed term loan and subsequently get bank or building society finance, it is important there is a clause in the mortgage giving you the right to repay your fixed-term loan before its maturity date. If there is no such clause, the lender can demand you pay interest for the whole of the term of the loan.

Vendor finance — one trap to avoid

Another option is vendor finance — this involves the vendor becoming a mortgagee, effectively agreeing to a delayed payment of the price of the property. These loans are usually of a fixed-term type.

The way vendor finance works is like this. Suppose you agree to buy a property for $600,000 and have $300,000 of your own money — perhaps from the sale of another property. A bank is willing to lend you $150,000. The vendor agrees to accept $450,000 now and the other $150,000 is to be paid off over five years at an interest rate of nine per cent. So for the first five years of the loan you are paying off both the bank and the vendor.

If you take out vendor finance make sure you understand all the terms and conditions In particular, insist on a clause that allows you to repay the loan early without any interest penalties.

What costs are you up for?

Apart from the cost of borrowing money to purchase a home, there are many other expenses. When buying a property you pay a solicitor's fee and stamp duty on the purchase and mortgage. It is also advisable to get a pest and building inspection of the property. These fees vary from state to state but they can add up to several thousand — or even tens of thousands of dollars.

When selling, your main costs are solicitor's fees, real estate agents' commission, a mortgage discharge fee, and perhaps some advertising. Stamp duty, solicitors' fees and real estate agents' fees are usually calculated on a sliding scale. This means the more expensive the property the more you will pay.

How much should you pay your solicitor

This is a matter for negotiation with your solicitor. Most solicitors will give you an "all-in" quote in relation to buying or selling a property — provided there are no unexpected complications. You should find out not only what your solicitor will charge for their professional advice but also what "disbursements" will be involved. You will have to pay for such things as title searches, obtaining rates and planning certificates and in some cases company searches.

Your solicitor is obliged to give you an estimate of what charges will be payable by you — so do not be embarrassed to ask for this up front.

How to Negatively Gear Your Family Home

When you buy an investment property you are liable for Capital Gains Tax on any profit you make. You also have to declare any rent you receive as income. But you can claim a tax deduction for your interest costs and the costs of owning the property, e.g. management fees, insurance and council rates.

In contrast any profit you make when you sell your family home is exempt from Capital Gains Tax, although you cannot claim any tax deductions for the interest on your home loan or other costs associated with running your home.

In low-inflationary times consider negatively gearing your home

Your family home's exemption from Capital Gains Tax (CGT) is only relevant if you have a CGT liability. In times when house prices are falling or not keeping pace with Inflation the exemption from CGT is not worth anything. This strategy is not suitable if you own property in some suburbs where even in times of low inflation demand is such that prices show consistent increases significantly above the rate of inflation.

There are some circumstances where it may be worthwhile to negatively gear your family home by buying it through a company or family trust. You then pay rent, for occupying the home, to the family trust or your company.

Certainly you lose the exemption from CGT — but you can claim expenses such as mortgage interest, maintenance and land tax as tax deductions.

If you use this strategy your family trust or company also has to have other taxable income to offset the negative gearing losses on your family home. Another advantage of this strategy is that you are eligible for tax deductions every year your trust or company owns the property. If you own the property yourself you do not know what the price of the house will be when you sell. So you do not know whether the CGT exemption will actually be worthwhile.

If you think house prices are likely to be steady or only increase marginally above the inflation rate it could be tax-effective to negatively gear your own home.

Tax saving strategies when you move house

If you have substantial equity in your existing home and wish to "trade-up" to a larger home you could consider ways of buying the second house but keeping the first house as an investment property.

Always get the advice of a tax specialist before buying an investment property

Example: Suppose you buy your first family home for $200,000 and several years later the market value of the house is $500,000 and your mortgage is $40,000. You want to sell this house and buy one worth $700,000.

On first glance is does not make sense to keep the first house as the rental income will exceed the interest on the relatively low mortgage and other running costs. Also, even if a bank would lend you 80 per cent of the cost of the $700,000 house, the costs of servicing this debt would not be tax-deductible.

One way round this is to sell your first house to a family trust or company. You would have to pay stamp duty on the sale — but there would be no CGT because it was your principal residence.

In this case the family trust would borrow to buy the first house for $500,000. The interest would be tax-deductible — as would the running costs. You would receive $500,000 and borrow $200,000 to buy the second house for $700,000.

For this strategy to work your family trust would need other investment income to offset the negatively-geared loss from the $500,000 property. The two biggest costs would be stamp duty and land tax, payable when the first home becomes an investment property. Depending on the state where the property is located, stamp duty could be around $18,000. Stamp duty is a once-only tax. But land tax is payable every year. This again varies from state to state — but you could be liable for around $5,000 to $6,000 every year.

It is essential you consider all the costs associated with this strategy and your family trust has sufficient other income to take advantage of the negative gearing losses.

A trap to avoid with property trusts

Changes to the tax laws relating to building depreciation allowances in the May 1997 Budget could increase your CGT bill if you invest in a property trust. Previously, managers of property trusts were able to claim depreciation on the properties in their portfolio. In turn this depreciation allowance was passed on to investors in these trusts so some of the distribution they received was tax-free.

Under the new tax rules building depreciation remains a tax deduction but the indexed cost base of the property is reduced by the indexed value of the deduction. These new rules only apply to property bought after 13 May 1997 — they do not apply to property purchased before this date. The end result will be a larger CGT bill which will be payable on property built after 13 May 1997.

The following example illustrates the impact of the new tax laws.

Example: A new building is constructed at a cost of $200,000 and a 2.5 per cent per annum building depreciation allowance is claimed, for 20 years. The building is then sold for $400,000. Inflation indexation over the period was 50 per cent.

1. Investor bought before 13 May 1997

Sale proceeds	$400,000
Cost	$200,000
Building dep. allowance	$100,000 over 20 years
Reduction in cost base	nil
Original cost indexed by 50%	$300,000
Taxable capital gain	$100,000

2. Investor bought after 13 May 1997

Sale proceeds	$400,000
Less Original cost indexed by 50%	$300,000
Plus Reduction in cost base	$125,000*
Taxable capital gain	$225,000
Building dep.. allowance	$100,000 over 20 years

***Assumes an average 25% inflation indexation over the 20- year period.**

When investors realise the impact of this measure it could slow down activity in the property market as it is a disincentive to purchase or construct new properties. It also means that in future you will need to examine the portfolios of property trusts to find out which of their properties was acquired after 13 May 1997.

How to Evaluate an Investment Property

Before investing in a property it is essential to work out the rate of return you expect to receive. You can then compare this rate of return with returns from other investments such as fixed interest and shares.

The most widely used technique to evaluate property investment is called discounted cash flow. This simply entails "discounting" all future income and expenses from the property to a common date — called the net present value (NPV).

Let's look at a simple example of how to calculate net present value:

Example: A property is bought for $100,000 and total costs of purchasing the property are an additional $8,000. Net rental income — i.e. rent minus running costs such as council rates — is expected to be $11,000 per annum.

At the end of four years you expect to sell the property for $140,000 — with costs associated with the sale being $6,000.

To avoid undue complications the impact of tax has been ignored. However, the impact of taxes can be incorporated into this example by using after-tax cash flow figures.

End of Year	Event	Cash Outflow	Cash Inflow	Net Cash Flow	PV of $1@12%	Net Outflow	Net Inflow
0	Price	100,000					
	Purchase Costs	8,000		-108,000	1	108,000	
1	Rent		11,000	+11,000	.8928571		9,821
2	Rent		11,000	+11,000	.7971939		8,769
3	Rent		11,000	+11,000	.7117802		7,830
4	Rent		11,000	+11,000	.6355181		6,991
	Net Sale Price		134,000	+134,000	.6355181		85,159
							118,570

These figures simply mean that receiving $134,000 in four years time when the discount rate is 12 per cent is the same as receiving $85,159 today. Think of the discount rate as being a concept similar to inflation. So, $85,159 received today would buy you as much as $134,000 would in four years time if the inflation rate was 12 per cent per annum over the four years.

The net present value in the example above is **$118,570** minus **$108,000** = **$10,570**

Because there is a positive NPV when using a discount rate of 12 per cent it indicates the rate of return on this property is more than 12 per cent per annum. If you used a 12 per cent discount rate and found a negative NFV, the investment would be yielding less than 12 per cent.

The actual discount rate you choose can depend on a number of factors. It may be the interest you have to pay on borrowed money. Or it may be the rate of return you can get on other investments. Essentially, 12 per cent is a target rate of return.

Let's see what happens if the target rate is changed. Suppose the target rate in the above example was 16 per cent. The calculations would be as follows:

End of Year	Event	Cash Outflow	Cash Inflow	Net Cash Flow	PV of $1@16%	Net Outflow	Net Inflow
0	Price	100,000					
	Purchase Costs	8,000		-108,000	1	108,000	
1	Rent		11,000	+11,000	.8620690		9,483
2	Rent		11,000	+11,000	.7431629		8,175
3	Rent		11,000	+11,000	.6406577		7,047
4	Rent		11,000	+11,000	.5522911		6,075
	Net Sale Price		134,000	+134,000	.5522911		74,0079
							104,787

The net present value is **$104,787** minus **$108,000** = **—$3,213**

These calculations show that if your target rate is 16 per cent the investment would not be acceptable. You can also use the NPV technique to work out by how much the property would need to rise over the four-year period in order to achieve a particular rate of return. You can then assess whether you think property prices are likely to rise by this amount.

For example, in the situation where your target rate of return is 16 per cent the NPV of the net proceeds you need from selling the property must be $77,220 in order for the overall NPV to be zero. So you require a net sale price at the end of the fourth year of $139,818 ($77,220) to achieve a 16 per cent rate of return.

The NPV method allows you to determine whether a particular property investment is likely to achieve an acceptable target rate of return. To effectively calculate the NPV of a property investment you must first get accurate estimates of future cash inflows and outflows.

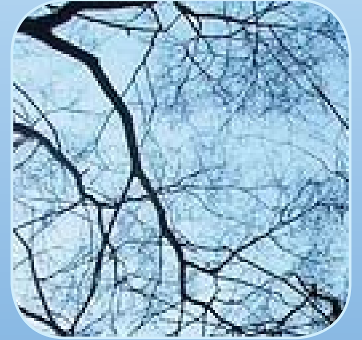
Exercise

Do a detailed cash flow of the future income and expenses associated with an investment property of your choice. Use the NPV method to calculate the rate of return you expect to achieve.

final reflections

What key points have you learnt from this module?

What are the four basic principles of property investing?



You are ready for the next module.