Compiled by Stuart Wemyss

Why off-the-plan investments often DON'T STACK UP

You will have seen the ads in the Saturday newspapers preaching the benefits of off-the-plan property investments. Stamp duty savings, rental guarantees, 'no need to pay for two years' are some of the common hooks used in these ads. In my experience, many dentists have been attracted to these investments probably because of these inducements and the fact that off-the-plan properties are heavily marketed to them. However, are these investments really worth making? I would argue that there are some fundamental flaws with off-the-plan property investments.

WHAT ARE OFF-THE-PLAN PURCHASES?

An off-the-plan property is offered for sale before it has been constructed. The developer will sell the property based on the plans that have been approved by the relevant authorities. The developer may also have concept drawings and perhaps even a mock apartment, so you can get an idea of how it will look.

A deposit is paid (often in cash, by a bank guarantee or a deposit bond) when a contract is signed. The remaining amount of the purchase price is paid when the property is completed and ready for settlement.

FINANCING

It is possible to obtain a finance approval for an off-the-plan property purchase. However, since most conditional approvals are only current for three months, the approval will often expire well before the property is completed, i.e., when you need the loan. Therefore, obtaining a formal pre-approval is often a waste of time. Instead, it is generally sufficient to make enquiries with a lender or mortgage broker as to your ability to be able to obtain sufficient finance. Of course, once you have signed a Contract of Sale for an off-the-plan purchase, you should be mindful that any changes in income and financial commitments may adversely affect your ability to be able to settle on the off-the-plan purchase.

However, don't be too relaxed about arranging your finances. Once the property has been completed, most developers give you 14 days notice to settle on the

property, so you must have your finances organised. To complicate matters, in my experience, most developments are never completed on time, so knowing when to have your finances ready can take a bit of guess work.

Three advantages

Pro: Higher rental income

A brand new property will often command a higher rental income. The reason for this is obvious – people like to live in a brand new sparkling property. The difference in income can be material. An existing older-style property could generate a rental yield of say 3 to 3.5%, whereas it is not unlikely that a brand new apartment would attract a rental yield of 4.5% or more.

Often, but not always, a higher rental yield is an indication that a property exhibits the potential for a lower capital growth rate.

Pro: Stamp duty savings

If a property is sold off-the-plan it means that a 'Contract of Sale' is entered into before the property has been constructed. Therefore, the 'property' that is under contract at the time of signing is really just the vacant land and as such the relevant State Revenue Office on levies transfer stamp duty on the land value, not the contact price. As a result, the stamp duty payable in respect to an off-the-plan purchase is often significantly less compared to an established property.

Pro: Depreciation (tax) benefits

For dwellings constructed after September 1987, owners are generally entitled to depreciate the cost of construction by 2.5% per year. This depreciation amount is included as a tax deduction at the end of the tax year thereby reducing your overall taxable income. Given it's a non-cash deduction, i.e., it's essentially just a mathematical deduction, it will increase an investor's cash flow. For a new $400,000 property, the deduction could potentially amount to over $10,000 in the initial year/s. If you are on the highest tax rate, it would result in a tax refund of $4,650 at the end of the year. This might sound very inviting. However, read the 'low land value component' paragraph below.

Pro: Potentially more market appeal

It's possible that you will enjoy a lower vacancy rate with an off-the-plan property for the same reason that you'll often achieve a higher rental income – wider appeal to tenants. However, one short-term issue is the initial letting of the property. The problem is, once a development is completed, all investors will put their property on the rental market. Therefore, the market is initially flooded with similar type properties. This means that it's not uncommon for a new property to initially be vacant for the first few months.

Four disadvantages

Con: Low land value component

Probably the most considerable downside to purchasing an off-the-plan property is that nearly always, the land value component of the purchase price is very low – often under 50% of the total purchase price.

Whist an apartment doesn't have its own portion of land like a house; there is always a notional land value component. For example, if a block of 10 apartments (same size) are constructed on a parcel of land worth $2 million, each apartment has a notional land value component of $200,000. When investing in property, you should always maximise the land value component.

A debt advisory client of ours settled on an off-the-plan property in late 2007. The purchase price was $390,000 of which $130,000 was the land component – being one third of the value – this is considered too low!

Why is a high land component important? Simply because land appreciates in value and buildings depreciate. Therefore, with the above example, the $130,000 land component will hopefully appreciate in value over time. However, the building component of $260,000 will depreciate thereby pulling the overall property's value down. We suggest investors demand a land component of above 50% when purchasing an apartment. Anything less will probably not perform well over the long-term.

Con: Price is set by the developer, not the market

When an existing property is put onto the market, potential purchasers can look back through sale records and see what the subject property has sold for in the past. They can then use these past sales results to extrapolate a current value. However, an off-the-plan property's sales price is set by the developer. There is no past sales price as a reference. Therefore, it is more difficult to establish what the 'market' value is. When the developer sets the sales price, they generally do so by working out how much the property has cost to construct and then adding a profit margin on top. If the property isn't going to be ready for a year or so then they will probably add in an additional margin for 'future growth'. Don't forget all the expensive market... it's all factored into

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the price. Therefore, there is a greater risk of potentially paying too much for a property.

Con: Often sold to majority investors

When buying an apartment, it is better if the other apartments in the same block are majority owned by owner-occupiers. There are a few reasons for this including the fact that owner-occupiers tend to take better care of the building, they will often assist with pushing prices up over time (as they are motivated more by emotional factors rather than pure financial factors) and it will mean less apartments are available for rent (so less competition and therefore lower vacancy). The issue with off-the-plan developments is that they are often marketed and sold to majority investors. You might find that some investors will want to sell the apartment once it's finished, so the market can be flooded with the same property stock in the first year or so. This does nothing for the property values.

Con: Can't inspect the property

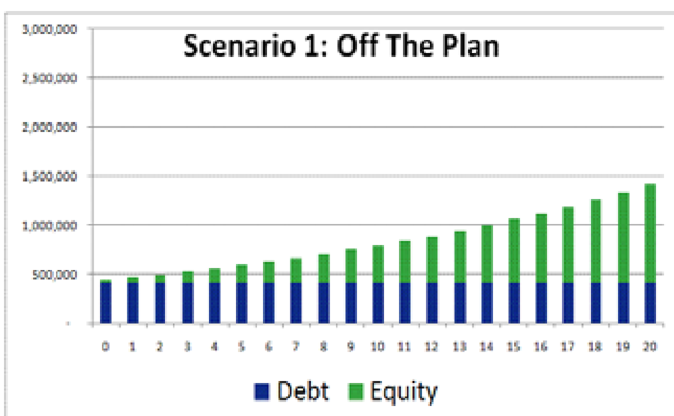
It is difficult to buy a property off-the-plan.You can't walk through the property, you can't visualise the size of each room and how the furniture might work, you can't ascertain how much natural light each room has, you can't see the quality of the finish, you can't ascertain noise levels – you get my drift. Dimensions are not what they seem – rooms always end up looking smaller. This is a big risk as you could end up purchasing something vastly different to what you thought you were buying. However, by comparison, you can walk through an established property and ascertain its quality and liveability. You also have the benefit of hindsight. You can see how the building has stood the test of time – often a good indication of the quality of the construction.

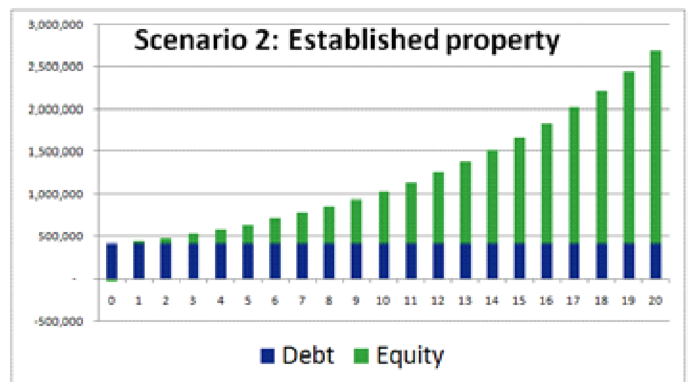
OUR ANALYSIS

As I continue to repeat in many articles, asset selection is absolutely critical with successful property investing. That is, ensuring you have the best quality asset possible is the most important thing. The true value of a property lies in its ability to appreciate in value in the future. Of less relevance is the purchase price compared to the current value. Let's look at some numbers.

Scenario one (Fig 1) involves purchasing a property off-the-plan for $400,000. Assume that the property's value once completed is actually worth $440,000 (so you have made a quick 10% gain). The rental income is also superior at 5% (say $420 per week). You borrow $408,000 to finance this purchase (purchase price plus costs – reduced stamp duty).

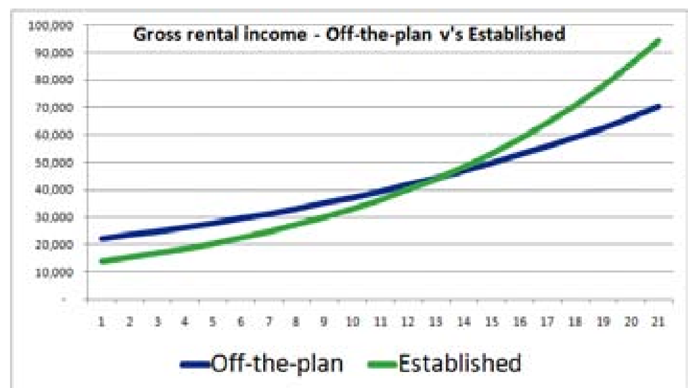
Scenario two (Fig 2) involves purchasing an established high quality property for $400,000 (its true market value – so no equity gain). The rental income is also lower at 3.5% (say $270 per week). You borrow $425,000 to finance this purchase (purchase price plus costs – full stamp duty).



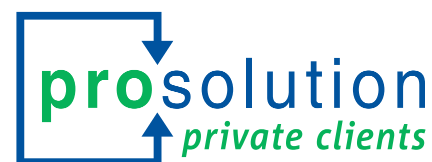


These graphs illustrate the difference in equity over the long-term. The established property generates over $2.2 million of equity in 20 years compared to the off-the-plan property with approximately $1 million of equity (as I have assumed a long-term growth rate of 10% for the established property and 6% for the off-the-plan property because of less scarcity and less land value).

The gross rental income from the established property also outstrips the off-the-plan property over time as illustrated graphically in Fig 3 (by year 13). This is very important as in the longer term you'll value a higher rental income as you'll be closer to retirement.



There are some short-term benefits with off-the-plan property investments including higher rental income, a possible initial spurt of equity and greater tax deductions. However, they are exactly that – short-term benefits. The longer-term benefits that high quality established properties provide more than outweigh the shorter term benefits offered by off-the-plan investments. There are just too many risks associated with buying off-the-plan. Why take the risk? A safer solution is to buy an established property. Therefore, if you are investing for the long-term (which most people should), please don't be seduced by the seemingly attractive benefits of a brand new investment property, because it's likely there are far better investments you can make. If you're unsure, seek advice.



Finance for Professionals, by Professionals

Stuart Wemyss is a qualified Chartered Accountant and is a Director of mortgage broking firm ProSolution Private Clients which specializes in arranging residential home and investment loans for dentists. Phone/ contact details???