Trilogy news
"the property investor's mortgage broker"

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6 FINANCIAL CONSIDERATIONS FOR BUDDING PROPERTY DEVELOPERS

Manufacturing capital through a property development project is a great way to boost your investment portfolio's profitability.

However if not managed appropriately from start to finish, you run the very real risk of over-capitalising and realising a loss instead of that much anticipated gain.

As a property investor, why would you waste valuable time and money on a project that might belly flop due to poorly managed timeframes and budget blowouts?

It does happen though, with problems often arising as a result of poor financial planning. Here are 6 financial considerations you'll need to work through in order to give your development a firm footing.

1. Your borrowing options.

Borrowing to undertake a development is a very different proposition to applying for a relatively straightforward mortgage. For a start you represent a higher security risk, so lenders will be a lot stricter when it comes to their criteria.

Not only will they carefully assess the viability of your proposed project, they'll also consider your experience and that of the team you put together to see the construction process through.

It's likely your choices around the types of loans and associated facilities you can access, as well as the lender, will be somewhat restricted.

For instance, depending on how many units you intend to build lenders will consider your project to be 'residential' or 'commercial residential'. If they decide on the latter, your mortgage options are immediately diminished.

You'll also need more upfront funding of your own if it's a larger scale development of say, four plus units. Typically, you can obtain 80 per cent of the final project cost from the banks (not its end value) if you plan on building 2 dwellings on site.

Whereas 3 or more units would require a lower LVR of around 70 per cent and the lender will ask you to chip in with a greater amount of existing equity and/or presales.

2. Your application.

Your submission must be professional and demonstrate appropriate due diligence that accounts for all identified contingencies.

Present your application as you would a business plan and include as much relevant detail as possible, including:

- the scope of works and anticipated timelines
- the amount of money required and how much you're contributing
- cost projections and a concise budget for the build from start to finish
- risk assessment and explanations of how you'll mitigate identified risks
- qualifications and expertise of the project manager and major contractors involved
- feasibility study
- projected sales figures and net gains
- site description, floorplans, architectural designs and zoning

3. Effective budgeting and cost management.

Budgeting and management of project funds is essential to your success. The banks will baulk if you don't appear to have all your fiscal ducks in a row. And your lender certainly won't be pleased if you approach them half way through the build to ask for more capital due to poor planning.

Account for every potential cost, including fixtures and fittings, as well as timing of things like pre-sales in your budget forecasts. Get all build quotes in writing to avoid conflicts with suppliers down the track.

You should also include a generous contingency, of at least 5 per cent of the estimated funds required.

Remember, your bank won't hand over the entire capital at time of loan approval, but will meter it out in instalments as follows:

- deposit
- base stage
- frame stage
- lock up stage
- fixing stage
- completion balance

Careful number crunching reduces your risk of coming up short at some point throughout the project, and ending up with unpaid contractors walking off the job.

4. Keep it real to avoid over-capitalising

The majority of property developers fail because they get carried away with design aspects and/or mismanage the project budget from the outset.

Some get caught up in the creative process and before you know it, are building palatial townhouses with executive fit-outs in an area where the predominant market happens to be young families rather than high paid executives.

A property development is a massive undertaking and as such, the end figures MUST stack up before you turn that first sod. Aim to achieve a profit margin somewhere around 20 per cent gross (at the very least).

And keep these figures in mind when working out…

5. The project's feasibility

It's essential to conduct a thorough feasibility study on any potential development, beginning with a critical assessment of the location and site you're considering.

- How much does the site cost?
- What is the zoning?
- How cooperative is the local planning authority?
- Will demolition of any existing dwelling(s) be required?
- What does the local property market look like?
- Who are the predominant owner-occupier and tenant demographic in the area?
- Will you on-sell all product or retain for tenancy purposes in your portfolio?
- What projected capital growth and/or yields can be achieved if you hang onto the completed properties long term?

Answering these questions will give you a much clearer idea as to whether the project will be worth tackling in the long run. Remember, this is about big picture stuff as well as the smaller details.

6. Timing

There are so many steps to take and boxes to tick when it comes to a property development project.

Staying on top of it all can be challenging for the novice, so it's advisable that you contract an appropriately qualified and experienced project manager to coordinate the build from start to finish.

The process should look something like this…

1. Before you even look at land, work out your finances and engage a mortgage broker, real estate agent (to consult about the local market), solicitor, architect and development manager.
2. Speak with the local council and from there, come up with a concept.
3. Secure your land at a commercially viable price to ensure the project will be profitable.
4. Apply for development approval – this process can take many months of to-ing and fro-ing with the local planning department, so account for this in working out your project timings.
5. Have working drawings prepared to obtain a building permit.
6. Get some quotes from local builders and trades and finalise construction finance.
7. Construction phase starts and generally lasts anywhere from 6 to 12 months, depending on the project scale and how well it's managed.
8. Employ your exit strategy (which will have been devised well before you started!).

WARREN BUFFET'S TOP 5 TIPS FOR PROPERTY INVESTORS

As regular readers of the Trilogy Report will know, we love our lists. Particularly when they have to do with successfully investing in property.

So when we came across this little gem from arguably one of the world's most respected and profitable investors – and guru to many who seek to follow in his footsteps – we had to share it with you!

While this Warren Buffet nugget actually dates back to early last year, the principles he speaks of are timeless and can easily be applied to your own investment journey.

1. YOU DON'T NEED TO BE AN EXPERT. The key instead is to recognise your strengths and limitations and based on those, follow a course that's tried and tested and certain to achieve your goals.

"Keep it simple," says Buffet, "and don't swing for the fences. When promised quick profits, respond with a quick 'no'."

I would add, in terms of strengths and limitations, be prepared to actively seek appropriately qualified guidance in any areas you're not necessarily confident approaching on your own. No one is an expert at everything.

2. FOCUS ON THE FUTURE PRODUCTIVITY OF THE ASSET. You need to be able to crunch some numbers and make comfortable and realistic estimates of any future potential earnings from the investment in question.

Buffet says omniscience isn't necessary, "you only need to understand the actions you undertake."

3. FOCUSING ON PROSPECTIVE PRICE CHANGES INSTEAD OF FUTURE PRODUCTIVITY IS SPECULATING. While Buffet concedes that he doesn't have anything against speculation per se, he's personally never found it to be effective and is therefore skeptical of others who claim sustained success with this approach.

"Half of all coin flippers will win the first toss; none of those winners has an expectation of profit if he continues to play the game," Buffet explains. "And the fact that a given asset has appreciated in the recent past is never a reason to buy it."

Of course history can be a very good indicator of future potential, but as Buffet rightly points out, you also need to be aware of the direction any particular market might be heading in for the term you plan on holding the asset.

4. DON'T JUST COUNT THE RUNS ON THE SCOREBOARD IF YOU WANT TO WIN THE GAME. Buffet refers to two 'small investments' he made some time ago in demonstrating this point.

One was a 400-hectare Nebraskan farm acquired for $280,000 in 1986 and the other, a joint venture retail investment purchased in New York a few years later.

Buffet says at the time, he only thought about what the properties would produce and didn't really care about their daily valuations.

"Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard."

Don't get caught up in the ebbs and flows of property cycles when evaluating the performance of your assets. This is about keeping your eye on the prize and having a 'big picture' mindset when it comes to your portfolio acquisitions.

5. GETTING CAUGHT UP IN MACRO MARKET PREDICTIONS IS A WASTE OF TIME. Buffet says all the noise that accompanies data sets and forecasts is dangerous as it can "blur your vision of the facts that are truly important."

He suggests it's easy to be an 'expert' from the comfort of a commentator's position – observing rather than playing the actual game.

Instead of being influenced by the views of others, your investment journey should have its grounding in an analysis of your own personal circumstances and objectives, aligned with a strategy suited to that personal analysis and your overall risk profile.

At the end of the day, everything else is just someone else's opinion.

ARE AUSTRALIAN PROPERTY MARKETS SET FOR A SLOWDOWN IN 2015?

Around the beginning of each year, it's interesting to take stock of where we've been and where forecasters predict we might be headed in the sometimes-tempestuous world of Australian residential real estate commentary.

The last twelve months have been a time of great opportunity for investors to break into housing or grow their already established property portfolios.

While many homeowners who thought the 'Great Australian Dream' to be unattainable had their faith restored, as continuing low interest rates and aggressive bank competition for new mortgage business made property far more accessible than it had been for some time.

Finishing on an investor high

Property investors were feeling pretty good about housing as 2014 came to a close, claiming around 50 per cent of all new dwelling loans at the end of December - the highest ever recorded.

Overseas investors were further fuelling the fire under house values, along with continuing strong population growth, with Australia's capital city property prices increasing by an overall 7.9 per cent across last year (according to CoreLogic RP Data).

Riding high on the real estate wave, Sydney in particular has experienced a much needed resuscitation of its housing market, clamouring back with a healthy 13.4 per cent growth rate across 2014 and 15.2 per cent in 2013 (RP Data).

It's important to remember that this came off the back of a prolonged period of stagnation across the Harbour City in general though, and as such is more a necessary recovery than unexpected 'boom'.

Naysayers keep making noise

Of course these steady conditions are not enough to prevent the likes of Steve Keen, head of economics, politics and history at London's Kingston University (and long time antagonist of Aussie real estate), from talking potential bursts of a so-called 'property bubble'.

Keen says two things could put the brakes firmly on dwelling values across the 'Lucky Country', being:

1. A **rapid economic slowdown** that causes negative returns in the rental market to become excessive. Keen refers to our unique negative gearing environment, implying that the financial burden of holding housing assets is being passed on to the general population through tax incentives for property investors.

2. A serious downturn in China. Although Keen concedes that this could go either way for the fortunes of Aussie property values, with the potential for more Chinese investors looking to park their capital in our housing markets as opposed to local assets.

Are our markets faltering?

While alarmists from abroad such as Keen like to make lots of noise about impending market crashes, the reality for Australian realty is actually a lot less alarming, according to local analysts.

For one, what many overseas commentators fail to account for is that Australia is a vast continent, where there are markets within markets.

As such, to make generalizations about the state of our 'housing sector', as though it's one gigantic mechanism is seriously misguided.

Local analyst and managing director of SQM Research Louis Christopher, has criticized recent bluster from some of his counterparts who suggest Sydney house values are set to back right off in 2015.

Although Christopher concedes that continued growth in the vicinity of 15 per cent is unsustainable, he says if interest rates remain low or fall further as some predict, we won't see a marked deceleration in the city's prime property enclaves.

Speaking with The Adviser, Christopher suggested SQM's forecast for Sydney property across the 2014/15 financial year, would be around 8 to 12 per cent growth.

"Over recent summers – and including this one – we have been getting the usual commentary from the usual suspects stating the market is about to slow down or is slowing down," he observed.

"It is increasingly feeling like the boy who cried wolf. Sooner or later they will be right, but right now, a slowdown currently happening in Sydney? Hardly."

What about elsewhere?

As for the rest of the nation's capitals…

Christopher says tidings are looking increasingly optimistic for **Melbourne** after a drop off in December, which was most likely due to standard seasonal market fluctuations as opposed to a loss of favour among property punters.

And while concerns regarding a glut of new CBD apartment stock, set to come on line over the next 12 to 18 months are warranted, Christopher says that vacancy rates overall have experienced a slight downward trend since 2013 and stock levels remain relatively tight.

News isn't so rosy for **Darwin** property investors, where vacancy rates have been on a steady upward trajectory, sending rental prices plummeting by a significant 14 per cent across last year.

Christopher says data for **Perth** is producing conflicting forecasts, with vacancy rates trending high on the one hand, while asking rents for residential accommodation is creeping upward on the other.

"It could just be a statistical aberration in the ongoing down market," says Christopher. "It is possible too, it may represent a signal of the bottom in the market."

He reports that sales remained steadily flat across the Perth housing sector in 2014, and are expected to continue on this slower course throughout 2015, on the back of the commodities downturn.

Christopher says the **Canberra** property market has also been a difficult beast to read of late, with initial impressions of a bottoming in the rental sector being overshadowed by a rebound in December's vacancy rate back to 2.3 per cent.

"That said the sales market appears to be strengthening as stock on market is trending down, implying that supply is being absorbed by home buyers."

Christopher says locals in the capital city are likely taking advantage of a weaker market and lower interest rates to move up the property ladder.

In conclusion

Christopher says now is a good time for property investors to operate in, "If you do your research and study how each region is moving and what is influencing these movements."

Overall, it's about keeping abreast of the various macro and micro fundamentals and importantly, having a sound understanding of the specific real estate market you're working in.

DEBT - IS THIS 'DIRTY WORD' KEEPING INTEREST RATES AT RECORD LOWS?

Australia's property markets have benefited greatly from the record low interest rate environment of the past eighteen months.

And while consumer confidence has seemingly erred on the side of scepticism in general (according to various business surveys), most of us have been feeling pretty good about the ongoing reliability of local bricks and mortar assets.

But the perpetual question property investment pundits are faced with – around this same time each month! – is how long will our environment of 'cheap' debt continue?

The Reserve Bank's bind

A number of economic commentators (both here and abroad) have insisted that an interest rate rise is necessary to put the brakes on some of our 'runaway' housing markets (namely Sydney!).

They fear investor borrowing in particular is creeping up into what many believe to be unsustainable levels for our banking sector.

Moreover, the concern is what happens if (and when) interest rates start to rise, and the thousands of households who've bitten off more than they can chew at a time when mortgages were more affordable (at today's rates), start to struggle?

Where will that leave our housing markets and the overall fiscal wellbeing of our nation then?

For longer than any other time in modern banking history, the RBA has maintained its conservative cash rate stance for fear that an already weaker Aussie dollar would dip lower, should even a quarter point rise take effect.

They simply haven't had the option to control dwelling prices with the usual economic policymaking. And it seems the rate rise card is becoming even less likely to be played as we look to the future and consider the question…

What will happen to debt-laden households if interest rates rise?

It would appear the Reserve Bank has been backed into a corner when it comes to increasing interest rates, and may not be able to play this hand for some time to come, no matter how badly they might want to.

In December last year, our average household debt to income ratio peaked at its highest level since March 2008 at 151 per cent, just shy of the highest ever recorded rate of 153 per cent.

To put it in perspective, this measure has tripled since the 1990s and means our debt levels are higher than most other developed countries.

Most of this debt is associated with home loan repayments. And the central bank is well aware that the monthly mortgage would become a far greater burden on already heavily encumbered Australian households, should rates rise anytime soon.

The RBA acknowledges that in NSW and Victoria, the share of household income needed to pay the interest on an average home loan over the next ten years was already at historically high levels.

In other words, most 'typical' households in two of our largest state economies are directing the vast majority of their budgets toward interest payable on property related borrowings.

Given that many of our overseas counterparts have experienced the housing busts many fear we face here in Australia, you can see how the RBA is pretty much up the proverbial without a paddle right now.

Particularly, when investors throughout the world are becoming increasingly concerned about our high debt load and how borrowers might cope (or not cope) if hit by an economic shock, including a sharp interest rate hike.

A word of warning

One day, perhaps sooner or perhaps later, things will turn around and the Reserve Bank will once again start to move rates onwards and upwards – this is almost as inevitable as death and taxes!

While it might not happen for some time to come, property investors and homeowners alike would do well to ensure you're in a position to continue servicing those mortgages when interest rates invariably start to creep up.

The good times will roll on for now, so by all means it's great to make hay while the sun shines. Just make sure you're also well prepared for a break in this 'perfect property investment storm.'