FINANCIAL REVIEW

How to get the best returns from property

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Investing in property is all the rage among self-managed super fund investors. But how do you know if you've invested in the right property, what sort of returns should you look for and which properties should you stay away from?

Brad Callaughan, director of accounting firm Callaughan Partners, says at the very minimum it's important to search for a good quality property with the potential for capital growth, and a minimum yield of 6 per cent.

"I would look for a residential property over a commercial property, unless you are a business wanting to buy your own premises," Callaughan says.

"There are two reasons I say this. First, finding a tenant for a commercial property can be difficult and also with business insolvencies at a high rate, there is a greater risk of being without a tenant. Second, getting a loan for a residential property is much easier than a commercial property, with banks requiring a minimum 30 per cent deposit, plus closing cost [for a commercial property]."

He notes it's often possible to buy two residential properties for the same outlay as one commercial property in an SMSF.

Says Callaughan: "I would also look for something that is new or a couple of years old. Yes, you get depreciation, but you also have lower maintenance costs with a newer property. You will also experience great growth on a newer property and it will hold its value better than a run-down house."

Condition and age

Chris Reed, specialist SMSF adviser with Business Concepts Group, agrees that the condition and age of a property are important factors to consider.

"Older properties may have significant ongoing repairs which can impact on both cash flow and investment returns. Newer properties will have greater tax benefits through depreciation, and tend to have lower maintenance expenses. It's also an idea to invest in suburbs that attract good tenants, who will pay the rent and look after the property, in areas with a history of steady capital growth."

St George’s head of SMSF trustee distribution, Sinclair Taylor, says investing in property is often attractive for small business owners. “It’s a common strategy for small business owners to consider owning their business premises through their SMSF, and then leasing the building back to their business. If you already own business premises you may be able to transfer the property to your SMSF, either as a contribution, sale or combination of both. “If you don’t already own the property you can buy it using cash within the SMSF or with a limited recourse loan from a bank or a fund member.”

Returns and costs

A critical consideration for SMSF investors before dipping their toes in the property market is returns and costs.

Greg Einfeld, director of Lime Super, says the trustees of an SMSF should be looking to achieve a total net return of at least 7 per cent to 8 per cent per annum, including rent and capital gains and net of fees. “If the SMSF is borrowing then it is important that the total net expected return exceeds the rate of interest on the loan, which might be around 6 per cent. Achieving a return higher than the loan interest rate can result in a very favourable outcome,” he explains. For example, he says, let’s say the fund has $200,000 cash and it borrows $600,000 at an interest rate of 6 per cent to buy a property for $800,000.

“If the total return of the property is 8 per cent per annum, then your return on the $200,000 invested is 14 per cent per annum. Of course this can work the other way too – if the return on the property is less than the 6 per cent interest rate, then the return to the investor will be low or even potentially negative.”

This highlights the importance of finding a property that will achieve a good long-term return.

According to Einfeld, costs should be built into the equation when estimating returns. “Up front costs include the establishment of the SMSF structure, stamp duty and legal fees. On an ongoing basis management fees, maintenance and levies tend to consume about one-third of rental income. “Some costs are fixed, regardless of the value of the property. For this reason, it is often not financially viable to buy property with less than about $200,000 in super.”

The trustees should also consider the cash position of the fund. Says Einfeld: “Usually the rental income plus contributions will comfortably exceed the loan repayments. But the situation can change if the members lose their jobs, or if the property is vacant. So it is wise to have a cash buffer in the SMSF.”

Off-the-plan

Of course not all properties are suitable for SMSF investment. Einfeld argues off-the-plan properties make terrible investments for SMSFs. “[They] tend to be overpriced, but buyers are attracted by glossy brochures with pictures of swimming pools and European appliances. They get caught up in the emotion and overpay as a result. Developers need to charge a premium for the properties to pay hefty commissions to financial advisers and real estate agents.”

He also warns investors that sometimes financial planners and real estate agents recommend off-the-plan properties because of the commissions, not because the properties will produce good returns.

“There is a huge conflict of interest here and most SMSF trustees are oblivious to it. Once the properties have been built, there could be hundreds of similar apartments in the building, all seeking tenants at the same time, so they are hard to rent. And when it comes time to sell, the chances are that there will be other properties in the building for sale as well. Or there could be a newer building next door, making your apartment look inferior in comparison.”

It is likely the properties will fall in value, or at least will not increase as quickly as other properties.

“One of the supposed benefits of new properties is depreciation tax benefits. But since tax rates in super are so low, depreciation has very little value; capital growth is far more valuable.”

Ironically, says Einfeld, a better investment is often an established dwelling where the previous owner has suffered the consequences of buying off the plan.

“In the case of apartments, smaller buildings in good locations are preferable to large buildings which have no scarcity.”

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