A GRACEFUL EXIT

You might not like to think about the end game, but when it comes to property investing, an exit strategy is a must. API chats with those in the know to learn how to exit the property game gracefully. **ANGELA YOUNG**

The whole point of investing in property, for most of us at least, is to accrue a degree of wealth and ensure we can retire in comfort.

In order for property portfolios to fulfil their obligations, therefore, there needs to be some sort of plan in place for what's happening towards the end of the game, which is where a structured exit plan comes in.

For both Open Corporation chief executive Cam McLellan and Empower Wealth's Ben Kingsley the most important message is simple: "Always start with the end goal in mind."

It certainly seems to boil down to the fact that one of the most crucial factors at the start of building your property portfolio is to think about what's going to happen at the end – and keeping it at the front of your mind throughout the life of your investing journey.

Kingsley advises: "You shouldn't be investing for the sake of investing, there should be some science behind what type of income you're trying to achieve from a passive point of view.

"If you're aspiring to get a self-funded retirement, you should be asking 'what does that look like?' 'How much are we going to need that's going to get us the comfortable lifestyle we want in retirement?'

"When I'm building property investment plans, the most important thing I focus on is that end goal.

"I start with that and reverse engineer the amount of properties that need to be bought, and I calibrate those properties based on their growth and rental yields and the debt we need to acquire and then ultimately pay that out."

As McLellan says: "Once your journey begins, it's easy to get distracted and stray from your path of systematic investment."

For him, there are essentially four main exit strategy options that you must consider at the start of your journey:

- Sell to pay off your debt.
- The domino effect.
- Make interest-only payments and live off equity.
- Give your portfolio away.

THE SELL-OFF

There are both pros and cons to this strategy, according to McLellan.

"From time to time you'll hear people toss around the saying 'work smarter, not harder', but the majority of people don't do this," he says. "Instead, people feel the need to be debt-free – they work hard to pay off the family home with income they earn from a job, and that's a big waste of time.

"Most people have been conditioned to think this way by their parents and society as a whole, but that doesn't make it a viable strategy.

"I can give you an example that shows why paying off the family home over 25 or 30 years with earned income is a bad strategy.

"Let's say you only ever buy three properties in your life. Two well-chosen investment properties bought at $500,000 each and the family home, also bought for $500,000.

- Two investment properties	$1,000,000
- Family home	$500,000
- **Total portfolio value**	**$1,500,000**

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"For simplicity's sake, let's assume the total loan amount is also $1,500,000.

"Remember, tax breaks and rental income will help you fund most of the loan repayments.

"As we know, well-chosen property will double in value about every seven to 10 years. That being the case, all you need to do to become debt-free is hold the investment properties through one full growth cycle and then sell them."

This, of course, would lead to your investment properties increasing in value from $1 million to $2 million.

"If you were to sell the two investment properties at this point for $2 million," McLellan goes on, "you'd incur capital gains tax of 25 per cent on the profit from the sales.

"The remaining amount available to reduce debt after tax will be $1.75 million.

"You can then pay back the $1.5 million debt on the investment properties and your own home, leaving you with $250,000 to play with."

It's a simple enough example of what you can do, although it's not the strategy McLellan recommends.

"Remember, if the rent is covering the repayments on your portfolio, what you have is good debt. It's worth examining whether your desire to reduce debt is due to society's deep-seated belief that all debt is bad."

For Kingsley, the sell-down isn't a first option either – the 'nirvana outcome' is living off the passive outcome.

"You have what we call the accumulation phase, where you're building up the portfolio, and then you focus on getting the debt out of that.

"So, ultimately, the best type of exit strategy for clients that you're trying to achieve is that the properties, and the income you've been earning while working, can pay out the debt and you live off the passive income. The exit strategy is that you get to hold on to the properties and live off that income while the assets also continue to appreciate.

"That's the nirvana outcome… where you might get $100,000 passive income and you're still in control of the assets."

Of course, this situation isn't always attainable, but there are alternative plans, Kingsley says.

"In the event we can't achieve this by the time a client's looking to retire, a couple of other things can happen."

Firstly, he says, you may need to be more realistic about how much income you're looking to generate from your portfolio.

"Secondly, you can look at ways you might be able to live off the equity. In other words, a good strategy might be that instead of paying the debt down you put it into an offset account – you build up that offset savings amount and that's part of the equity you live off, as opposed to doing a reverse mortgage, whereby you might reverse engineer the property to gain equity out of that, and live off that until sometime in the future it has to be sold.

"Both of these methods are effectively living off the equity in the property, by using the money you don't save up in an offset account while building up to retirement, or saying 'okay, I can do reverse mortgage'."

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>
> CAM MCLELLAN

THE DOMINO EFFECT

McLellan's second option, the domino effect, involves moving one of your loans to principal and interest, or even keeping it as interest-only but starting to pay off the principal from your excess cash flow.

"Once you pay the debt on this property, you can focus your increased cash flow on your remaining total debt," he says.

"Your interest repayments have been reduced because you've already paid off one house. This means you can pay off your next house in an even shorter timeframe, which is the 'domino effect'.

"As each loan or house is paid off, cash flow improves and subsequent loans are paid off faster, until you're debt free. This is a reasonable strategy to use while you're still working and it means you can have a stress-free retirement with a solid income."

He does point out, however, that in reality, to truly become debt-free or to fast-track your wealth building, you may need to use the selling exit strategy in conjunction with the domino effect.

"Neither of those is my preferred option. My choice is to make interest-only payments and live off the equity gains and increases in rental yield."

He explains the relatively simple process: "Once I'd achieved an increase in my portfolio's value, I'd have my portfolio re-valued. I'd then create a line of credit with the banks, which would allow me to use those funds to live off. It's an ideal situation, as long as your portfolio grows in value faster than your living expenses."

The question, it seems, is if your portfolio is supporting your loan repayments and providing you with an adequate income, why pay them all off?

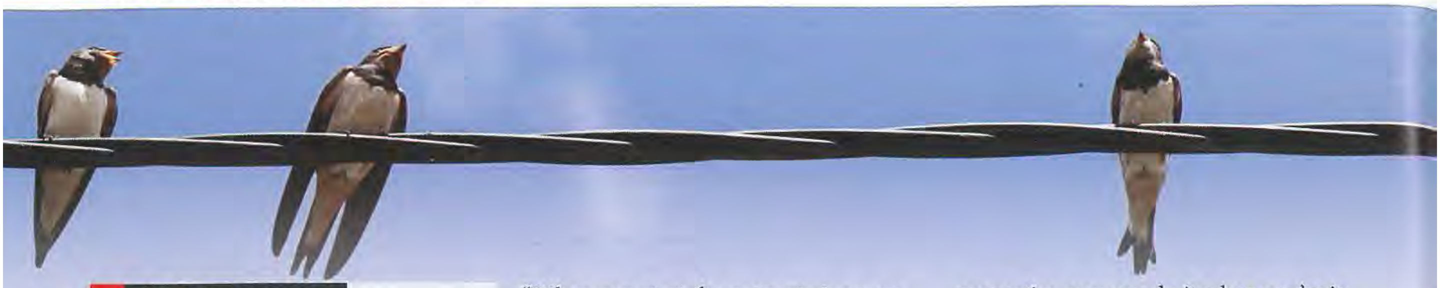
You can simply have your portfolio at a positive or neutral cash flow position and leave it to increase in value, living off the equity gains in the meantime. Of course, this will only be a satisfactory strategy if the value of your portfolio increases on average at a faster rate than your yearly expenses.

GIVING THEM AWAY

Another exit strategy that doesn't involve selling your entire portfolio is to hand over your properties to your offspring.

"If they're smart enough to handle it," McLellan says, "you can use this strategy in conjunction with any of the others. You simply transfer control of a portfolio that's held in trust by appointing a new company director. The actual asset never changes hands, so no tax is incurred. You're simply signing across control of the asset's holding entity."

Kingsley points out that rather than just handing over the portfolio, asking for help can be an option.



THE ONE-YEAR RULE

John Tsoulos reminds us we need to remember the one-year rule when thinking of selling off properties.

"The government gives you a 50 per cent tax-free component on your capital gain, but if you sell within the first 12 months there's no tax-free, so you'll pay tax on the whole gain," he says.

"If you sell it on the 366th day, all of a sudden you get a 50 per cent discount. And the benefit is it'll keep going up in value over time, so it makes sense to look at that as part of your planning.

"Remember: the important thing is the contract date, not settlement.

"So, if you bought a property at a really good price and someone comes along and says 'I'm gonna give you $100,000 more', and you think that's a great way to go, you've got to be very careful.

"If your settlement is in the 14th month but your contract is within the 12 months, capital gains actually apply from the time of contract."

"Family members can assist in maintaining the asset base, because ultimately they're going to inherit them! That's another way of looking at it."

TAX TIME

For McLellan, an exit strategy is "all about minimising tax and maximising returns". And there are many ways to achieve this.

"When you start the property journey, you should start by ensuring properties are in the right structures, because down the track when you want to sell, they'll all have different tax consequences," Indigo Financial's John Tsoulos says.

For example, he explains that buying property through a company isn't necessarily a good idea, as companies aren't privy to capital gains exemptions like individuals are, so the company will be paying the straight tax rate of 30 cents in a dollar.

Tsoulos, too, cites the trust route. "If you've got property in trust, you can distribute income and capital gains to different people, and that way you can minimise your tax on sale – that's why structuring at the start of your journey is very important.

"Another thing you could do is part-sell – you might have some properties that you think have grown quite a bit in value over time, and you might sell those and keep some of the others."

A strong argument, perhaps, for maintaining a portfolio with both cash flow positive and capital gains properties. Another interesting avenue is self-managed super funds.

"There are a lot of people out there, since the rules changed four or five years ago, that are buying residential and commercial property within super, because you can now borrow to do that," Tsoulos says.

"When you're looking at selling these properties, you can do it when you're in a pensions faze – you pay no tax."

Planning ahead is definitely a rule of thumb, it seems. And if you're thinking of selling, it pays to do it in a year where your income is low.

"If you're earning a lot of income this year, you'd look at contracting the property sales in the following year, and maybe spreading them about a bit, to minimise your tax and not get one big hit in a particular year," Tsoulos says.

The longer you hold, the more you pay off, and the higher the value of the property is likely to creep. It's a win-win!

In the future, Kingsley sees us treading new paths.

"It's early days yet on some of these types of things, but you'll see a bit of fractural investing, where potentially people sell a portion of their property or they do a vendor finance deal, where they stay in their asset and sell it to someone else.

"They get the gain, but they get to live in the asset until they pass. You might be asset-rich but cash flow poor.

"You could say, 'Okay, I'll sell the asset but the deal is I get to live in it for the next 10 years, rent-free. Or I pay a small rent.'"

That way, you get to realise the value in your asset but still retain the property until you're ready to move, into a retirement village perhaps. Another strategy worth considering to ensure you can make a graceful, and lucrative, exit. API