PROPERTY

**STORY** BRYCE HOLDAWAY

# Go for the CASH COWS

## Rental property is a great source of passive income as long as you can be patient – but in the long term it can really pay off

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**A GREAT WAY TO BUILD** passive income for life is through a residential property portfolio, one based on the relatively secure and stable base of bricks and mortar. An investor who makes the effort to learn how to optimally grow their capital base while not "risking the farm" – that is, by taking a conservative approach – can enjoy the fruits of their labour in a rather simple and straightforward way.

However, caution is needed. While it is relatively simple to do, it's certainly not easy, as you'll need to self-assess whether you have two key personal characteristics necessary to successfully build the passive income of $25,000: having patience and being comfortable with debt.

I'm a huge believer in the power of residential real estate to provide financial stability and security but I'm not an advocate of it being seen as a get-rich-quick scheme or simply property speculating. In fact, I'm suggesting you will need to wait at least 10 years before you reach your income goal, which may not necessarily be the news that some adrenalin-seeking investors would like to hear.

Equally, if you want to enjoy a passive income during the best years of your life, it's likely that one property simply won't be enough and you will need to be comfortable with the idea of leveraging into multiple properties.

More and more people are open to the idea of investing in property but, according to the Australian Tax Office, of all the property investors who lodge their return, 73% stop at one property. Hence my point that, while it is simple to understand, only a small minority actually do take the property investment leap for a second time.

The type of properties to consider for this income-focused strategy are what I would call "cash cows" – essentially properties that are getting better than average rental yields while still having a reasonable expectation of moderate growth. I have adopted this combination to be 6% growth (3% excluding inflation) and 6% yield in the portfolio that I've suggested. These properties are typically found outside the 15km radius of the main CBD employment centres.

With interest rates at historical lows, it is reasonable for many investors to be cash-flow neutral or positive at this price and yield point with current rates. I would caution against buying in overly speculative locations that provide higher short-term rental yields. You only have to look to the mining town story over the past 12 months to see how many investors are now highly exposed due to commodity price volatility and its flow-on to lower valuations and diminishing rents in those areas.

The strategy shown in the table illustrates a conservative path to a $25,000 passive income and has factored in all reasonable costs for building the portfolio, including maintenance and interest rates (closer to the long-term average) as well as the expenses of holding the portfolio each year.

### BUILD YOUR PORTFOLIO TO DELIVER $25,000-PLUS

| TIME LINE | | | ASSUMPTIONS | |
|---|---|---|---|---|
| 1-Jul-15 | Buy $300,000 property, 6% yield, 6% growth | Capital needed $75,000 | Each $75,000 would be from a line of credit secured against other property, such as the family home; you would need $300,000 worth of equity. | |
| 1-Jan-16 | Repeat | Capital needed $75,000 | | |
| 1-Jul-16 | Repeat | Capital needed $75,000 | $55,000 is the estimate of total out-of pocket expenses to pay interest, rates, insurance, maintenance etc until the portfolio becomes self-funding (6 years). | |
| 1-Jan-17 | Repeat | Capital needed $75,000 | | |
| 1-Jul-21 | Cash-flow positive | $55,000 holding costs | | |
| 1-Jul-25 | $25,000 income ($19,000 in today's dollars) | Staged debt retirement Portfolio value: $2m | To be debt free in October 2038 all surplus cash flow (from the portfolio, from July 2021 onwards, and nothing else) is placed into offset accounts to reduce net debt, while the cash is still available. | |
| 1-Jul-29 | $50,000 income | Staged debt retirement Portfolio value: $2.5m | | |
| 1-Jul-34 | $100,000 income | Staged debt retirement Portfolio value: $3.4m | Management cost 7.7% | Purchase costs 5% |
| 1-Oct-38 | $233,000 income | Fully debt free Portfolio value: $4.5m | Maintenance 0.8% | Mortgage interest rate 6% |
| 1-Jul-43 | $233,000 income | If debt is not retired | Growth 6%pa | Inflation 3% |
| | | | Yield 6% | |

It takes only an additional four years to get to $50,000pa and a further five years to **double that to $100,000pa**

In this case, the total costs are about $55,000 until the portfolio becomes cash-flow neutral. (My modelling doesn't factor in any depreciation benefits and related tax refunds as they are investor-specific outcomes.) But if they were available, they would provide further financial upside in this plan.

In terms of price point, I have suggested purchasing a $300,000 property initially with three subsequent $300,000 purchases at six-monthly stages until there are four properties in total in the portfolio.

I'd consider this entry point as comfortable for most to consider and allows us to realistically achieve 6% rental yield to reach our $25,000 income goal.

Releasing equity from the existing family home has been factored in as the basis for borrowing the deposit and costs. This will provide sufficient funds to complete settlement and ensure that the lending on the investment property does not exceed a loan-to-valuation ratio (LVR) of 80%. With that in mind, each property will require an independent contribution of $75,000 in equity, which represents a 20% deposit of $60,000 and purchase costs of 5% or $15,000.

The key outcomes of this portfolio are:

- It is cash-flow neutral by July 2021.
- The $25,000 passive income is achieved by July 2025 (10 years from now).

According to Core Logic RP Data, the following are examples of suburbs or towns that will give a 6% yield while having a historical 6%-plus capital growth rate that could support this portfolio's goal:

- Tahmoor, NSW – unit, median $297,500.
- Northam, WA – house, median $278,000.
- Ourimbah, NSW – unit, median $301,000.
- Windale, NSW - house, median $275,000.
- Boggabri, NSW – house, median $264,000.

To build this portfolio, you would need existing equity of $300,000 to leverage against when funding the purchase of each investment property. But if that level of capital were not available, there are three suitable alternatives, of which two are more realistic.

The first is to use lenders mortgage insurance (LMI) and the related costs, which would allow you to borrow up to 95% of the purchase price and effectively reduce the amount of equity in your family home or other assets that you need to offer the lender as security.

The second would be to team with someone – for example, parents, other family member or friend – who has equity available and would be willing to allow you to use it as security for the lending required.

The third alternative is to save for the deposit and costs. But, unless you have a significant income that allows for a "material" surplus cash flow, this is often a constant game of catch-up as your rate of savings struggles to keep pace with the growth of the properties' values.

The exciting aspect is that, while it takes 10 years to reach $25,000 in passive income from the portfolio, it takes only another four years to double that to $50,000pa and another five to double that to $100,000pa. (This more than offsets that the $25,000 reached in year 10 has inflation built into the growth and in today's dollars it's equivalent to about $19,000.)

Importantly, if you chose to leave the income in the portfolio and use it to retire the debt – rather than for discretionary spending – you would achieve the passive income in a shorter time. Interestingly, if you left all the income there until all debt was retired, then at about October 2038 you would have a passive income of $233,000pa with no debt and a portfolio that would continue to grow in value each year.

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