



INVESTORS



Bryce Holdaway,
Director, Empower Wealth and
co-host of Foxtel's Location,
Location, Location Australia

»»» How does a zero-deposit strategy actually work? How do you go about using the equity in your home to buy an investment property?

THE EQUITY IN YOUR home is a powerful wealth-creation tool that you can use to buy an investment property without using any of your own savings. It's a strategy often used by experienced investors, but how does it work?

Let's consider a couple in their 30s, Daniel and Rebecca, who want to buy an investment property for \$450,000 and, like most people in this situation, they would find it difficult to save a deposit with their \$424-a-month surplus. Equally, in the time it would take to save a deposit, property prices would continue to grow and they would be forever chasing the market just to get in. By using the equity in their home they can enter the property market straight away by following these five steps:

1. Release equity

The first step would be to set up a facility to release the equity in their principal place

of residence so that they can have access to working funds for a 20% deposit and settlement costs such as stamp duty and solicitors' fees, typically 5% of the purchase price. It's possible to release this equity at 90% loan-to-valuation ratio (LVR), but I would suggest they adopt a conservative approach and borrow up to 80% LVR. This would look like the following:

\$575,000 x 80% = \$460,000.

However, they already have an existing mortgage of \$310,000 so this would need to be adjusted and therefore the releasable equity would be:

\$460,000 - \$310,000 = \$150,000.

Typically, this \$150,000 would be a facility such as an available line of credit (LOC), as you only want to draw down these funds as you need them.

2. Pre-approval for 80%

The next step is to get pre-approval for the purchase of the \$450,000 investment property for 80% of the value: \$450,000 x 80% = \$360,000.

With this strategy we structure stand-alone loans, whereby we separate Daniel and Rebecca's home from the investment property and offer only one security (the new investment property) for this pre-approval. The alterna-

tive is cross-collateralisation, which is where the bank secures the loan for the investment property with security from two properties - ie, their home and the investment property. However, we'd prefer to avoid this approach as it gives the bank too much control and reduces the couple's flexibility with purchasing their next property.

3. Purchase investment property

Once an investment-grade property is found, Daniel and Rebecca will need to provide a cash deposit on signing the contract (usually 10% of the purchase price) to secure the deal. This would be paid using their line of credit (LOC) and the flow of money would be as follows:

LOC funds available \$150,000
Minus \$45,000 deposit
LOC balance \$105,000.

4. Provide funds to complete at settlement

This is where the strategy all comes together. Just as they are not using their own savings to fund the deposit, they do not want to pay any of the settlement costs out of their own pocket either. To complete the \$450,000 purchase the following overall funds would be required:

20% deposit \$90,000
80% balance \$360,000
Stamp duty and costs \$22,500
Funds required to settle \$472,500.

So, at settlement their solicitor or conveyancer will look to them to pay the outstanding amounts and, given part of the deposit has already been paid and the 80% balance will be paid by the lender, the balance of the deposit and the stamp duty and costs would simply come from their line of credit.

The money flow at settlement would be:

LOC funds available \$105,000
Remaining balance of 20% deposit \$45,000
Stamp duty and costs \$22,500
LOC balance \$37,500.

This remaining amount would act as a buffer for Daniel and Rebecca for any future costs as well as give them additional peace of mind. It could also be used to consolidate other high-interest debt such as store cards or credit cards, which would free up additional cash flow each month to put towards their investments.

5. Enjoy the journey

»»» Pros and cons of using your equity to invest

PROS

Match "capacity" with "intent". It is extremely difficult to save your way to retirement as life

just gets in the way with all of the other financial commitments you have, so the desire to invest in a property is often blocked by the lack of the extra financial capacity necessary to do it. Accessing equity to invest means that capacity meets intent.

Start immediately. There is no need to wait until you've saved a deposit. By using your equity to access "other people's money" from the bank, you can use "your money" to cover other household spending items such as the groceries, education, car upgrades and holidays. This can make a big difference when it comes to retirement and can mean a significant difference in the equity position at retirement (see table, right).

Employ "lazy" equity. Gets an otherwise idle asset - the equity you have in your home - working for you and, when done sensibly, it can be effected with little or no impact on the family budget.

Interest tax deductible. Interest payable on money borrowed to purchase an income-producing asset is typically deductible against that income and, in the case of property, against other income.

Return on cash outlay. If you are not putting any of your own money into the investment but rather you are investing with no cash outlay, then "cash on cash" return as a percentage is highly desirable and rewarding.

Lower rates than unsecured loans. By offering the security of real estate as collateral to access the funds, you can get better rates of interest than if you have to fund a deposit through other unsecured lending options, such as a personal loan.

CONS

Easy money. Sometimes the best financial discipline comes from the life skills you acquire to come up with the money yourself. Easy access to credit is both a strength and a weakness, depending on your attitudes towards money. In the wrong hands, the ease with which you can invest may be detrimental to you overall situation.

Cash flow shortfall. While accessing equity can make buying an investment property easier, it is still important to consider the ongoing costs of holding the property - they can be easily overlooked - and how this would impact on the family cash flow.

Your home as collateral. Your home is being used as security for borrowed money and the lender may want its money back if the investment goes pear-shaped, which makes some investors feel uncomfortable. I know plenty of

CASH FLOW

INCOME

Daniel's annual income	\$80,000
Rebecca's annual income	\$40,000

MONTHLY CASH FLOW

Joint monthly income after tax	\$8042
Bills (basic expenses)	\$2156
Lifestyle & discretionary spending	\$2750
Mortgage payment	\$2712
Total monthly spending	\$7618
Monthly surplus	\$424

WHY INVEST NOW?

THE DIFFERENCE 10 YEARS CAN MAKE

	INVESTOR A: INVEST NOW	INVESTOR B SAVE 10% DEPOSIT
Today (age 40)	\$450,000	-
Year 5	\$661,200	-
Year 10	\$971,500	\$971,500
Year 15	\$1,427,500	\$1,427,500
Year 20 (age 60)	\$2,097,450	\$2,097,450
Capital gain	\$1,647,450	\$1,125,950
Difference	\$521,500	

Capital growth of 8%pa assumed

USING YOUR HOME

ESTABLISHING A LINE OF CREDIT

Value of principal place of residence	\$575,000
Mortgage still owed	\$310,000
Equity	\$265,000
Usable equity (80% of home value less existing debt)	\$150,000

FIRST INVESTMENT PROPERTY

Investment property value	\$450,000
20% deposit (\$45,000 paid already)	\$90,000
Loan required	\$360,000
Stamp duty and buying costs (about 5% of price)	\$22,500
Funds needed to settle	\$472,500
LOC remaining	\$37,500