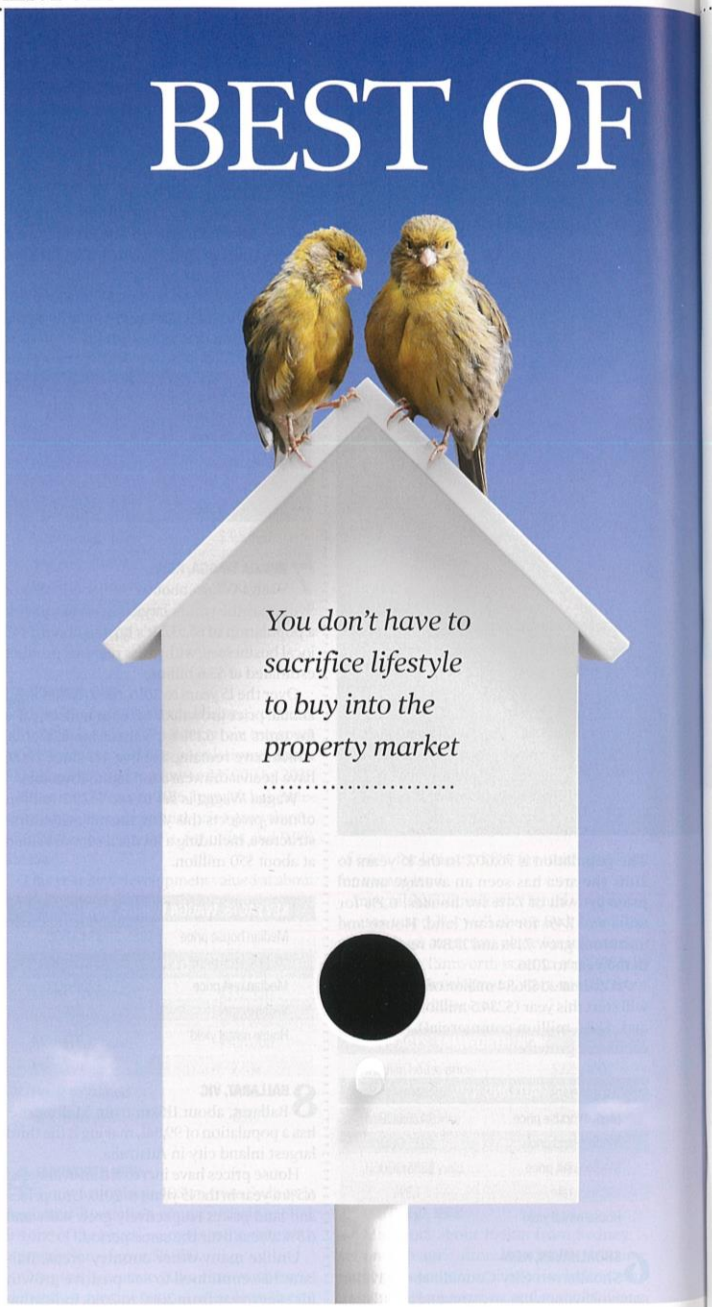
BEST OF BOTH WORLDS



You don't have to sacrifice lifestyle to buy into the property market

STORY BEN KINGSLEY

A growing trend among younger property buyers is challenging the traditional thinking about the great Australian dream of home ownership – a trend where early adopters are being financially rewarded when it comes to the buying-versus-renting decision.

It's called "rentvesting", whereby a person or family elect to rent where they want to live but still invest in property for their financial future. In simple terms, if you could afford to buy in a particular location and the mortgage repayments were $2750 a month, yet to rent a similar property in the same location cost $1750pm, then you would have a spare $1000pm to invest.

If you chose to invest these spare funds, then the goal would be to build up a property portfolio that grows in value, brings in passive income in the form of a rent role, and better still you get to live in a location you want, with all the lifestyle perks you want.

Rentvesting is a strategy that has emerged because of current property market pressures. Since the boom in Sydney and Melbourne, some property prices have increased beyond the reach of many willing buyers to make the repayments on a large mortgage, yet renting in these same locations is within the budget of those same buyers.

It's fair to say that a decade or two earlier there were probably fewer high-value locations in our capital cities where most people couldn't afford to buy and the differentials between price and rent were not as high. And people were less likely to choose renting over buying unless they had to.

Now fast-forward to today, with a growing population and the fact that there is a finite supply of land in these areas, generally in the inner city. The lifestyle and its attractions such as proximity to the city, beach and good schools are difficult, if not impossible, to find elsewhere and prices have soared as a result of the strong demand.

So rather than lowering their expectations about location and lifestyle, as life is too short – switched-on people are turning what many might see as a negative into a positive and benefiting from the best of both worlds: they are living where they want to live but also investing in property in other locations for the future.

For such people, rentvesting will be a compromise they can live with when it comes time to make the call between buying or renting.

But is the strategy simply a compromise or can it be even more – a smart, long-term wealth-creation strategy?

THE PROS

LIFESTYLE

If it's too expensive to buy where you want to live, then you still have the option of renting. There are many reasons why you may want to live in a particular area: better schools, greater safety, a bigger house or proximity to lifestyle amenities and perhaps family.

WEALTH BUILDING

Because you are saving on mortgage repayments and investing those savings into a portfolio of properties, you are not missing out on building a retirement nest egg.

COST SAVINGS

Buying a home has high acquisition costs such as stamp duty and conveyancing and lending fees, which might include expensive lenders mortgage insurances (LMI) as well. A rule of thumb these days is that 6% of the cost will be one-off items – more if LMI is payable. So if you are buying an $800,000 house, expect these one-off costs to be more than $48,000, which you don't get back when you sell.

ALL CARE, NO RESPONSIBILITY

For tenants, it's the landlord's responsibility to maintain the property. Any issues with the electricals, hot water, leaks, air-conditioning, building deterioration, inbuilt fixtures and fittings and worn items are the landlord's cost.

EASE THE BURDEN

Your tenants and the tax office help out financially. Initially when you buy an investment property, the rent covers a portion of the loan repayments. Additionally, depending on how much you borrow, there might be a shortfall (loss) between the income you receive and the cost of running the property. When this occurs, the loss is subtracted from your other income, which reduces your overall tax bill in that year. Over time as the loan is paid down, the rental income becomes greater than your outgoings and after you pay tax the difference is passive income for you to enjoy or plough back into an investment.

TAX BENEFITS

With the investment property, you can claim depreciation on the building, plus the fixtures and fittings. This is in addition to your initial costs and will result in reduced tax.

GO WITH THE FLOW

Because you don't have the high cost burden of buying (or selling, for that matter – up to 2.5% of the sale price), the world is your oyster. You can rent for a few years near the beach, then try inner-city living for a while or escape to the country. Renting gives you that flexibility and potentially a variety of accommodation types. Due to high buying and selling costs, it's not financially sensible to do this as an owner.

THE CONS

LOSS OF FULL CGT EXEMPTION

Capital gains tax is one issue that rentvest doubters might raise. Your own home is regarded, from a tax perspective, as your principal place of residence and this carries a full exemption from any tax liability if you sell the property for a profit. On the other hand, if a rental property is sold for profit a portion will go towards CGT. This amount varies subject to how much profit is made, the overall income in that tax year and how long you owned the property before selling it. Obviously, if you don't sell it no capital gains tax is payable.

EMOTIONAL COST

Many of us grow up dreaming of one day buying a property and making it into our home where we can add personal touches. In a rental property you need the landlord's permission if you want to change anything substantially.

LOSS OF CONTROL

A major frustration when renting is finding a suitable place and then moving in all your belongings. It's even worse if the landlord decides you must move out. It's their property and they have ultimate control over it.

PEER PRESSURE

Residential property is the domain of owner-occupiers: they own about 70% of the market. So as you get older and more "responsible" the pressure builds on you to buy a property of your own even if you can't really afford it or you have to settle for one that's not completely suitable or is in an area you don't like. And when you do buy, you do your very best to convince yourself, family and friends that it was the right decision.

"RENT MONEY IS DEAD MONEY"

I've included this point as a con because if someone decides to rentvest but doesn't get around to actually investing or only puts away some of the savings, the strategy won't work. The key is to invest that surplus money, otherwise it is likely you would have been better off financially with the buying-to-live-in option. When it comes to decisions about our living circumstances, personal and traditional preferences will play a part. But so too should the financial implications. To illustrate this, on the following pages we have set up a real-life scenario that compares buying a property to live in with renting and investing.

REGULATORY RISK

With housing affordability dead centre in the political landscape and the rapid growth of properties in our two biggest cities, residential property investment is being tinkered with in terms of lending and tax changes. Our political parties have different views on negative gearing and capital gains, and potential changes in this space could affect property values, making it a less attractive investment.

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CASE STUDY

NAME: STEVE, 27; INCOME $75,000pa
DEPOSIT: $100,000
SITUATION: CAN'T AFFORD TO BUY IN INNER CITY
STRATEGY: RENTVESTING WILL ALLOW HIM TO LIVE WITH MATES AND INVEST FOR HIS FUTURE

Meet Steve – he's 27 years old. His financial situation looks like this: Steve has been living at home with his parents, which has allowed him to save a decent deposit of $60,000 and his parents have gifted him $40,000. He's had a good run at home but now his parents are looking to move onto the next stage of their lives and are considering downsizing, hence to gift to help him with his deposit.

He is considering his options for entering the property market – whether as a first-time own-home buyer or as one of the growing number of "rentvestors".

He's keen to live near the action and like-minded young people. This means he wants to be close to the beach, city and lifestyle of inner Melbourne which, like any modern and large city around the world, isn't cheap for property buyers. His initial research has shown him that to buy the type of property he wants it could cost him more than $700,000. If he had a mortgage of $665,000 at 6% interest, his repayments would be almost $40,000 a year – and that would just be the interest without paying off any principal. This is totally unaffordable.

Interestingly, properties similar to what he is looking at (two-bedroom units) are being rented for $24,000 a year. So if he shared with a flatmate, his rent would be $12,000, or less than a third of what it would cost him to service the interest if he tried to buy and didn't take in a renter to help him with the mortgage.

STATE OF PLAY

	BUY TO LIVE IN	RENT-VESTING
Gross wages	$75,000	$75,000
Living costs	-$23,000	-$23,000
Purchasing power	$495,000 (wages only)	$570,000 (wages + rent)
Buying costs	$17,015 (FHB benefit)	$45,420 (LMI)
Mortgage	$414,608 (83% LVR)	$517,782 (88.5% LVR)
Surplus cash	$2593	$2542
AFTER PURCHASE		
Outgoing rent		$12,000 (share apt)
Gross rental income		$20,976 (5% yield, 92% occupancy)
Rates, upkeep	-$7425	-$8600
Property mgmt (7.7%)		-$1600
Loan repayments (6% interest-only)	-$24,876	-$31,067
Depreciation claimed		$3459pa (for 20 yrs)
Income tax payable	-$17,500	-$9900 (after dedns)
Surplus cash	$2199	$9809

Top location ... for Steve, proximity to the beach is important.

Disappointingly for Steve, even if he wanted to buy, the reality is that his maximum borrowing power is $415,000 based on his income and living expenses. If he uses all his savings as a deposit, his maximum purchase price is $495,000. This budget simply won't allow him to buy where he wants to live or the type of place he wants.

However, if he rentvested he could use the rental income from the investment property he buys, in addition to his wages, to boost his borrowing power. Based on this scenario, his maximum borrowing power is $520,000, so his purchasing power is $570,000 once you add his deposit.

Let's look at the numbers in the tables and compare the two options.

What jumps out after the initial purchase is the cash flow story for the rentvestor. The rental income, combined with the lower tax payable, means Steve is able to hold a higher-value asset yet still have solid cash flow of almost $10,000 a year compared with just over $2000 a year if he bought.

Looking 10 years into the future we see the financial differences starting to appear: combining all the benefits, the rent he earns is significantly more than the rent he pays, the tax benefits of investing and the interest saved by putting the surplus cash generated into his offset account shows only a small difference of $4650 in net debt. If you look at his overall net worth Steve appears to be $129,700 better off (if he continues to rent).

Furthermore, the investment property is now funded 100% by the tenant and is generating net passive income to the tune of $4400, which will increase further over time. At this point it's worth pointing out that this surplus cash flow would accommodate another investment property purchase and the compounding effect of such a strategy could reap even greater wealth returns. But for the purposes of this exercise, we have modelled just the single investment property.

If Steve stays this course for 20 years the numbers look even more appealing. It's true that 20 years is a long time and a lot can happen that could alter this result. In both scenarios he would have been in a position to buy additional properties. Alternatively, he may have decided to increase his rent to have his own place rather than have a flatmate. Steve could have met his future life partner and started a family, which could have resulted in the sale of whichever property he decided to buy. All that said, when comparing his buy versus rentvest decisions, it's important to consider the financial impact. At 20 years the positive cash flow could be a healthy $46,650 a year and growing given there is no mortgage debt remaining.

When you combine the forecast property value increase and his cash assets, Steve would be better off financially to the tune of over $380,000 over 20 years if he rentvested. This is serious food for thought for any younger person considering their property future. *M*

COMPARING FUTURES

	BUY TO LIVE IN	RENT-VESTING
AFTER 10 YEARS		
Gross wages	$101,800	$101,800
Living costs	-$41,850 (incl prop costs)	-$31,650
Outgoing rent (5%pa)		-$19,850 (share apt)
Gross rental income		$37,550
Rental property expenses		-$14,400
Mortgage interest (with offset benefit)	-$18,850	-$18,750
Income tax payable	-$24,650	-$25,500
Surplus cash	$4700	$9750
Savings in offset acc	$23,950	$85,000
Net mortgage debt	$321,350	$326,000
Property value (@ 6%pa)	$886,450	$1,020,800
Net worth (excl super)	$565,100	$694,800
AFTER 20 YEARS		
Net property income		$46,650
Surplus cash	$16,850	$17,900
Savings in offset	$122,500	$101,800
Net mortgage debt	$40,200	none
Property value	$1,587,550	$1,828,050
Net worth (excl super)	$1,547,350	$1,929,850

Income and expenditure indexed at 3%pa

WHEN DOES IT WORK?

In simple terms rentvesting works best when there is a good-sized differential between what it costs you to buy versus what it costs you to rent. So if holding costs include 6% in interest and 1.5% of the property's value in holding costs, that's a total of 7.5% ongoing; versus renting at, say, 3.5% of its value, the differential is 4%. It's this differential that creates the financial benefit of rentvesting. Furthermore, the higher the property value based on the principal of compounding return, the greater the financial benefit.

WHO DOES IT SUIT?

Given the recent regulatory changes, it works better when incomes are higher, as it increases the level of borrowing power to purchase a higher-valued property. In addition, given the initial negative gearing benefits, the higher the investor's tax rate the better.

THE BEST LOCATIONS

It's not a strategy that works well if the differential between buying and renting doesn't clearly exist. In other words, it's not a strategy recommended in locations where buying the home would be roughly the same cost as renting in that area. It usually works best in higher-value areas close to the major capital cities, as this is where large differentials between the buying and renting costs are found. And if you think about that logically, if properties in these locations were affordable to all, this differential wouldn't exist. But I don't know anywhere in developed economies and cities around the world where you can find cheap housing close to major capital cities. (Note that our model assumes a slower rate of growth for rents in these areas than for rent on the investment properties.)

AN EARLY ADVANTAGE

In playing devil's advocate, you might be thinking that surely those who chose to buy the family home could at some point buy an investment property as well – and this is true. However, as clearly illustrated in the modelling, every time it might be possible for an owner-occupier to invest, the rentvestor is in a position to invest earlier and add to their portfolio, which would further increase the financial differential in the rentvestor's favour.