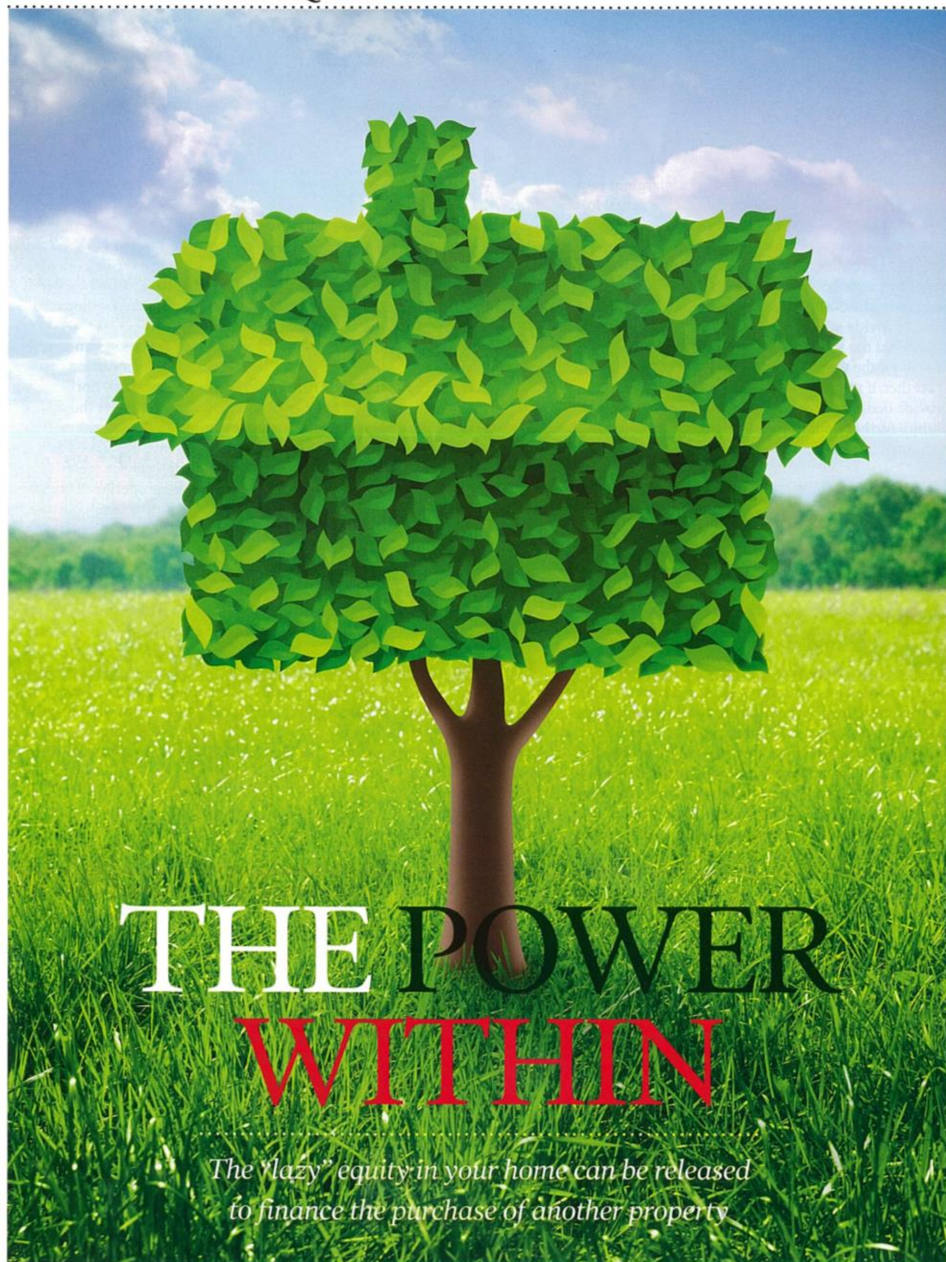


THE POWER WITHIN

The "lazy" equity in your home can be released to finance the purchase of another property

STORY BRYCE HOLDAWAY

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 $500,000 and, like most people in this situation, would find it difficult to save a sufficient deposit with their $716-a-month surplus. Equally, in the time it would take to save a deposit, property prices would continue to grow at a faster rate than they could accumulate their funds 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 steps:

RELEASE EQUITY

The first step would be to set up an investment facility to release the equity in their principal place of residence, which is valued at $620,000, so that they can have access to working funds for a 20% deposit and settlement costs such as stamp duty and solicitor's fees, typically 6% of the purchase price. It's possible to release this equity at a 90% loan-to-valuation ratio (LVR) but I would suggest they adopt a conservative approach and borrow up to 80% and avoid lenders mortgage insurance in the process. This would look like the following:

- $620,000 x 80% = $496,000
- However, they already have an existing mortgage of $310,000 so this would need to be adjusted and therefore the releasable equity would be:

  $496,000 - $310,000 = $186,000.
- Typically this $186,000 would be an investment facility such as a line of credit (LOC), as you only want to draw down these funds as you need them.
- Pre-approval for 80%.

The next step is to get pre-approval for the purchase of the $500,000 investment property for 80% of the value: $500,000 x 80% = $400,000. 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 alternative is cross-collateralisation, which is where the bank secures the loan for the investment property with security from two properties – their principal place of residence and the investment property. We'd prefer to avoid this approach as it gives the bank too much control and reduces this couple's flexibility with purchasing their next property.

- Know your home's market value.
- Check the current loan balance.
- Have all the paperwork ready – payslips, bank statements and statements of other debt. This can speed up your application for funding.
- Your maximum borrowing may be capped at 90% of your home's value. Lenders mortgage insurance will apply if you borrow 80% or more.
- Use the opportunity to shop around – check whether your current loan is still the right choice for you.

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 and the flow of money would be as follows:

- Line of credit funds available $186,000.
- Minus $50,000 deposit.
- LOC balance $136,000.

PROVIDE FUNDS TO COMPLETE AT SETTLEMENT

This is where the strategy 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 purchase the following overall funds would be required:

- 20% deposit $100,000.
- 80% balance $400,000.
- Stamp duty and costs $30,000.
- Funds required to settle $530,000.

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 $136,000.
- Remaining balance of 20% required deposit $50,000.
- Stamp duty and costs $30,000.
- LOC balance $56,000.

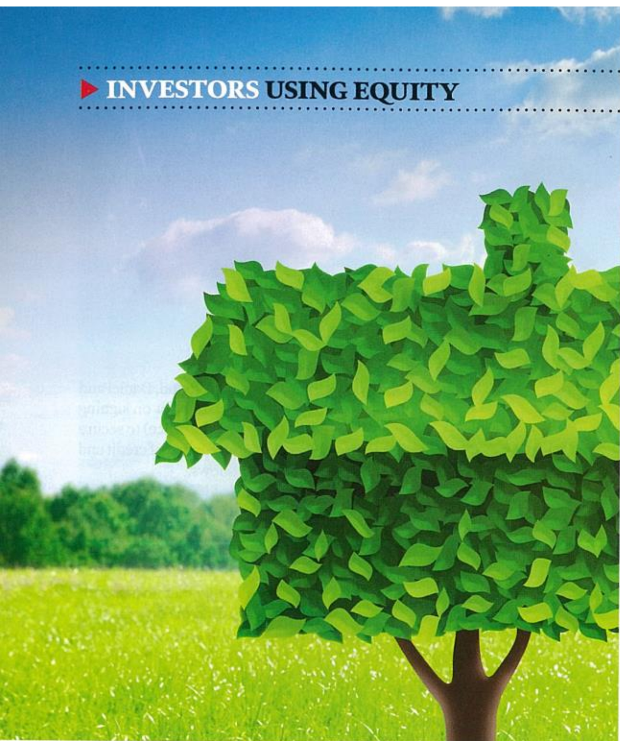
This remaining amount would act as a buffer for Daniel and Rebecca for any future costs as well as give them additional peace of mind. It could also be used to consolidate other high-interest debt such as store cards or credit cards, which would free additional cash flow each month to put towards their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

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. 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.

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 done 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.

CASH FLOW

INCOME	
Daniel's annual income	$80,000
Rebecca's annual income	$50,000
MONTHLY CASH FLOW	
Joint monthly income after tax	$8526
Bills (basic expenses)	$2156
Lifestyle & discretionary spending	$2750
Mortgage payment	$2904
Total monthly spending	$7810
Monthly surplus	$716

Lower rates than unsecured loans. By offering the security of real estate as collateral, 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 your 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 investors who are happy to use equity in other properties but will not touch the family home.

THE RISKS AND HOW TO MINIMISE THEM

▶ OVERCOMMITTING

While you might be able to afford to service the total debt today, changes tomorrow could result in cash flow pressures on the household. Interest rates are at historically low levels and a buffer should be factored in for rate increases. Very few people make good money holding a property for less than 10 years.

tip **Get a detailed cash-flow model done, including the performance of the asset as well as household cash flows that incorporate all the family budget costs.**

▶ POOR ASSET SELECTION

Picking a poorly performing property whose value doesn't grow or, worse, falls and results in negative equity for you is a risk all investors confront. And let's face it, with more than 9 million dwellings in 15,000 or so suburbs to choose from, it's not always easy to know which property will make for a great investment.

tip **Invest in your own education to learn how to identify an investment-grade asset, or consider using a buyer's agent who is skilled in selecting investment-grade property to assist you.**

▶ BAD FINANCE STRUCTURE

Often the agenda of the banks is at odds with the agenda of the investor as the banks will want to set up a structure that gives them maximum control (for example, cross-collateralise the security) whereas the investor's goal is to improve their independence and increase their flexibility for future investing. Investors who are stuck with a bad loan structure will either incur high costs fixing it or hit glass ceilings where they can borrow more on paper but the bank won't approve any additional lending.

USING YOUR HOME

ESTABLISHING A LINE OF CREDIT	
Value of principal place of residence	$620,000
Mortgage still owed	$310,000
Equity	$310,000
Usable equity (80% of home value less existing debt)	$186,000
FIRST INVESTMENT PROPERTY	
Investment property value	$500,000
20% deposit ($50,000 paid already)	$100,000
Loan required	$400,000
Stamp duty and buying costs (about 6% of price)	$30,000
Funds needed to settle	$530,000
LOC remaining	$56,000

tip **See an investment-savvy broker who is familiar with the optimal finance structure for property investors as an alternative to approaching your bank directly.**

▶ KEY PERSON RISK

While the building of the property portfolio is important, it can all be placed at risk if one or more of the income earners were unable to earn an income for reasons outside their control – sickness or disability – so it's equally as important to protect the income earners.

tip **Seek the advice of a suitably qualified financial planner on how you can get some risk protection.**

▶ STEEP LEARNING CURVE

Just because you live in a property doesn't mean you will know how to invest in property. There are a number of things to consider over and above the bricks and mortar – finance, tax and tenant implications, to name a few – and the learning curve is steep on that first investment.

tip **Look to create a team of professionals who are experienced in building property portfolios rather than simply facilitating transactions. The key is to make sure they have no conflicts of interest.** M

Just because you live in a property doesn't mean you know how to invest in property

▶ TAP INTO A FORTUNE

The difference between what your property is worth and what you owe is your fortune waiting to be accessed. You can tap into this equity to invest in property or any other asset. It makes sense to have a clear idea of your home equity as a starting point. Your latest home loan statement will show the balance of your loan or you can simply ask your lender.

In putting a value on your home, websites such as propertyvalue.com.au and onthehouse.com.au offer free "guesstimates". Lenders' valuations tend to be conservative as they rely heavily on historical sales of similar properties.

How you structure your loans is critical.

There are two main options. The first is to increase your existing loan. The extra funds you borrow would be to fund the deposit of around 20% of the purchase price of the new property, plus costs such as stamp duty. A new loan is then taken out for the new property, potentially at 80% of its purchase price.

The advantages of this approach include the fact that the increase can be approved ahead of time and you can have the funds available in advance. Another plus is that you're free to choose a different lender for each loan. Finally, if you sell one property it won't impact the other loan.

It will mean there may be more paperwork as you will need to increase your existing loan plus apply for a new one. Set-up fees may be higher as you will have the cost to increase the loan and value the existing property, and set-up fees on the new loan. Plus the money you borrow for the investment property will be split between two loans, so for repayments and claiming interest there will be two loans to consider.

The second option is to cross-collateralise. For this the current loan is untouched, apart from this property being valued to calculate how much equity you have. You take out a new loan with the same lender up to the full purchase price plus costs. This loan is then secured by both the new property and your existing property. The new loan utilises the amount of equity needed to keep the lending proportion to 80%.

Although the set-up costs will be lower and it is simpler, there are limitations. You have to have both loans with the same lender, so it limits you if you want to shop around for a loan for the new property.

Issues can arise down the track because you have one of the properties securing both loans. If you sell one, then the security properties will need to be separated, which will require valuations on the remaining property and a restructure of the loan, potentially requiring a contribution to keep the loan to 80% of the remaining property. Also if you refinance, then either the loans will have to be separated or you will need to put both with the new lender. MARIA BEKIARIS