

feature prestige property

Positively swanky

Investors chasing positive cash flow shouldn't write off a property because it carries an expensive price tag. Done right, even million-dollar-plus properties can be self-supporting. **Terry Ryder**

"But I still haven't got over the drama of spending \$1 million on one property. It'll take a while to put it in the background."

CASH flow positive investments have become harder and harder to find as returns have contracted while interest rate bills have expanded. The rule of thumb is that the cheaper the property, the more likely you are to generate a scenario where the property pays for itself. Conventional wisdom says that as properties become more expensive, rental income falls further behind. Most real estate professionals would tell you that cash flow positive scenarios are impossible to achieve on prestige real estate. But, like many commonly held beliefs in real estate, it ain't necessarily so.

Real estate author and advisor Margaret Lomas, who has built a property portfolio with a positive cash flow policy, has recently added a million-dollar apartment to her stable – and like everything else in her 35-property portfolio, this luxury pad will more than pay its own costs. Lomas has combined an above-average rental income with extensive depreciation benefits to make a Sydney apartment with harbour views self-supporting.

Buyers agents, like Scott McGeever in Brisbane and Patrick Bright in Sydney, confirm from their experience that it is possible to own million-dollar property without dipping into your own pocket to pay the bills.

This is not for everyone. It's certainly not for someone early in their investment career. Only those with a substantial stable of properties should consider it. The commitment – and the

potential for financial problems if the strategy falters – is big.

This is partly because the success of the strategy depends on corporate letting, rather than a long-term lease to residential tenants. Corporate letting pays more but has greater potential for vacancies. Investors need the strength of a substantial portfolio – and/or a big income – to cover periods when the property is costing but not earning.

"It's not a recommendation I make to people, even though I've done it myself," says Lomas. "I wouldn't allow any of my clients to even consider it. You shouldn't put all of your eggs in one basket. For me that's not the case: in the context of my portfolio of 35 properties it's only about 12 per cent of the value. If it doesn't all work out as planned – and it would have to go terribly wrong not to work out – and I don't get that positive cash flow, I have lots of other properties to support it, given that my portfolio is very highly positive cash flow.

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The key elements of a million-dollar-plus apartment that pays for itself are these:

- buying well
- the right location
- higher income from corporate letting, and
- maximising depreciation benefits.

Lomas and her husband Reuben bought their apartment at

a very good price from vendors who needed to make a sale. Their research indicated very early that the property needed the higher income of corporate letting to stack up. Fortunately their target location, Milsons Point in Sydney, is a good spot for that style of tenancy.

The other essential quality to get the investment into positive cash flow territory was high depreciation allowances – and being a home with extensive fixtures and fittings, the Milsons Point apartment delivered big time.

Buying well

Lomas bought her apartment from vendors who'd paid considerably more a couple of years earlier. Indeed, it appears they paid too much in an off-the-plan purchase.

This is quite a common situation. Historically, the theory of buying apartments off the plan was that you signed up at today's prices and by settlement, perhaps two years down the track, the value would have grown.

Today the situation is often different. More and more developers factor those two years of growth into their sale prices. Off-the-plan buyers often buy at tomorrow's prices. The settlement figure will be the value at completion of the project, not the value two years earlier when the buyer signed the contract. If the market falls in the interim, the off-the-plan buyer has a big problem. And this occurred in many markets between 2003 and 2005 – those who signed off-the-plan contracts in 2003 may have had to settle in 2005 on a unit worth less than the contract price.

"The key to my purchase is that I didn't buy off the plan," says Lomas. "I bought in a building that's completed but still has unsold units. The people before us bought it off the plan at a projected future value – which subsequently proved to be an incorrect projection."

Lomas and her husband didn't set out to buy a luxury apartment in Sydney. They had a long-term plan to buy something near the harbour – perhaps in two to three years time – but no immediate plans.

"We had some time one morning coming down to Sydney for a property expo and decided to look at what was available in Milsons Point, just out of interest," Lomas says. "We eventually wanted to buy something we would live in ourselves in the future. We wanted a big balcony, we wanted views, but we wanted to avoid noise from the Harbour Bridge.

"We weren't ready to buy, but when we walked into this particular apartment, we fell madly in love with it. We had an opportunity the next day to find out more about the property – including the last price paid for it, which was \$1.35 million.

"We knew we couldn't afford \$1.35 million. We needed to get it under \$1.1 million to make it work."

After doing some research to determine that the property had the potential to be positive cash flow, it came down to

negotiating well to get it at the right price.

"Reuben had just done a course on negotiation," she says. "We knew the owners were selling because of a relationship split-up. We knew we had buyers who needed to get out. Little things along the way indicated we had a chance to buy it better than normal. We weren't prepared to go over \$1.1 million and we were ready to walk away."

They made a low offer and, after some to-ing and fro-ing, were surprised when the vendors accepted \$1.1 million.

Lomas believes there are ample opportunities like that for investors.

"In this price range, there are going to be plenty of circumstances where people have over-committed and have a forced-sale situation," she says. "Too many off-the-plan purchases just don't work out because the apartments are overpriced – and that's what happened here.

"It depends on the negotiation skills people have. If you're going to pay the asking price, you probably won't achieve the desired outcome."

Corporate letting

Luxury apartments at Milsons Point can command high rentals for permanent residential tenants – \$600 to \$800 a week is common – but not enough to create a self-supporting property. To stack up, it needs the higher incomes provided by corporate letting. There is a steady market in Sydney, created by companies bringing in executives from interstate or overseas who need accommodation of a high standard and in the right location for perhaps two to three months. They'll pay less than hotel accommodation but considerably more than a residential tenant. This means the apartment needs to be furnished – and to a high standard. (See March 2007 API for more on this).

"To make this work for us, we had to be able to put in a tenant," Lomas says. "I established what kind of a tenant market there would be for this property. I found I would get only \$800 a week for a long-term residential lease. But there was a fairly specific and well-established market for short-term rentals – not day-to-day but for companies who lease for two to three months for staff brought in from overseas. If I furnished it to a very high level I knew I could get \$1200 to \$1500 a week."

Location

The location is critical. The property needs to be where executives want to live. That means close to the action, within easy reach of the CBD, with views.

Milsons Point fits the bill in Sydney, perched on a peninsula under the Sydney Harbour Bridge, with train and ferry links to the CBD.

"In 99 per cent of cases I would suggest against corporate letting," says Lomas. "It won't work out well for you every

time. It has to be in exactly the right place. Milsons Point is the right place and this building is particularly well located. There's a train station 20 metres across the road and it's one stop to the city. A ferry to Circular Quay is close by as well and buses are available."

Apartments in this area tend to offer iconic views. The best have large balconies with outlooks including the water, the Harbour Bridge, the Opera House and the Sydney CBD.

That's part of the package that makes the location attractive for corporate letting clients and other upper-end tenants.

Depreciation benefits

These days a 6.5 per cent income return isn't enough, in itself, to cover today's interest rates and other ownership costs, but depreciation benefits can get you over the line. It's absolutely critical when an investor seeks a self-supporting investment at the upper end. Lomas' apartment made the grade because it offered fantastic depreciation allowances.

"It's also important that I can write off tax in the higher income brackets," she says.

After inspecting the apartment and before negotiating to buy it, Lomas focused much of her research on the impact of depreciation.

"(The depreciation firm) had already done the numbers of this particular apartment because the developer had used them, so I had the added advantage of being able to access the depreciation numbers ahead of time.

"It's around \$40,000 in year one. It's a higher-end apartment and it has everything in it, so there's a lot of expensive fixtures and fittings. I had a good idea of what it would cost to furnish the apartment and I was able to add that to my depreciation – if it cost \$30,000 to furnish it, I could add \$5000 to \$6000 to the depreciation allowances. But the depreciation on the furnishings wasn't so important because we get so much on the fixtures and fittings."

The information about these tax benefits made it easier to calculate how much income was needed to make the investment work on a positive cash flow basis. They had to average at least \$1100 a week.

"I was really surprised when I did the final figures. I said to Reuben: 'Can you believe it? That property is positive cash flow'."

Are there others out there?

Are there other such opportunities out there? Lomas believes there are. "If we found one, there are going to be others out there," she says. "A couple of years ago, you needed to go into ugly duckling suburbs to find positive cash flow properties. But now there are more expensive areas that are showing potential – they've plateaued in terms of their values but their rents have started to catch up."

An examination of the rents commanded in the best apartments in Milsons Point suggests there are possibilities.

Three-bedroom or four-bedroom apartments with spectacular views were commanding rents above \$1500 per week late in 2007.

One apartment in Lavender Street, looking across Lavender Bay to the Harbour Bridge and the city, was renting at \$2200 per week. The apartment offered three bedrooms, two bathrooms, a large balcony, two security parking spaces and a host of luxury features in a building with 24-hour security, on-site management, pool, sauna, spa, gym and close proximity to the Milsons Point train station.

Buyers agent Patrick Bright of EPS Property Search says he knows of top-class apartments with water views, bought for \$1.5 million to \$2 million, and fetching \$2500 to \$3000 a week in rent.

"They'll show you a pretty good, above-average return," he says. "You're talking areas in Sydney like McMahons Point, Kirribilli and Lavender Bay. The location is vital. But you need the kind of financial ability to buy those sorts of properties and be able to wear the mortgage payments when it might be vacant for a few weeks between tenancies.

In Brisbane buyers agent Scott McGeever, the president of the Real Estate Buyers Agents Association of Australia, says he regularly has clients seeking quality apartments for corporate letting to achieve a positive cash flow outcome. He says this is achievable in key inner-city suburbs such as Kangaroo Point, New Farm and Teneriffe.

"Often it's an ex-pat with plenty of money to spend and who can't get any upfront tax advantages, so they want a property that looks after itself," he says.

McGeever, who runs Property Searchers, says it's possible to buy an apartment for around \$700,000 and earn \$1000 a week through corporate letting (rather than perhaps \$600 a week through a traditional residential tenancy).

"To work, this needs to be somewhere close to the CBD but not necessarily in the CBD. It's got to be a property or a building that has something the rest don't. It has to have a point of difference. There are a few over at Kangaroo Point you can do that with, there are some along the river at New Farm, a few opportunities along the river at West End – and there are plenty of executive-let places at Teneriffe, around the Woolstores precinct.

"Corporate letting is quite strong in Brisbane because there are executives and professionals based in Sydney or Melbourne who are needed up here for infrastructure projects. I know a guy who works for a mining company, lives with his family in Sydney but the head office of his company is in Brisbane. He has an apartment at Teneriffe where he might stay four nights a week. The company pays above-market rent to have it available for him when he needs to be in Brisbane."

Melbourne buyers agent Michael Ramsay gets steady work from investors seeking quality apartments for corporate letting, as it can add 1.5 percentage points to the return – and, with depreciation benefits, can go close to paying its own way.

“I’m looking for three different clients at the moment,” says Ramsay. “They’re people looking for something to buy, furnish it and let it to the corporate market. You could never do it with a house but with an apartment it’s possible. The yields are always higher with an apartment.”

Ramsay says St Kilda Road, South Yarra and East Melbourne are prime spots to look and the ideal tenant is someone who stays for two to three months.

There are plenty of executive-style townhouses and apartments along St Kilda Road and in South Yarra commanding more than \$1000 per week in rent. A recent example was a three-bedroom, three-bathroom apartment on St Kilda Road with big views, many luxury features and secure parking for three vehicles, with an asking rent of \$1200 per week.

South Yarra possibilities included a four-bedroom, four-bathroom townhouse with two security car spaces, renting at \$1600 per week, and another with similar parameters asking \$1595 per week.

Other possibilities

Bright says some investors have created positive cash flow properties by buying a large two-bedroom home and converting it into three bedrooms, creating the ability to charge a much higher rent. Sometimes this has been achieved by using ceiling height to create a loft bedroom.

“Provided you don’t go too silly with your costs, you can increase your rent and get a higher yield,” he says.

But investors need to be careful.

“I’ve had people tell me they’ve done that kind of thing but they’re not always significantly better off in terms of cash in their pockets after allowing for the extra expenses. They might buy a \$500,000 property, spend \$50,000 on it to generate an extra \$30 or \$50 a week in rent – but are they any better off?”

McGeever says many investors in Brisbane seek to lift high-priced investments into positive cash flow territory by converting a large house into dual occupancy. Typically this happens with a large four-bedroom Queenslander close to the CBD, which can be converted into two two-bedroom tenancies, or one two-bedroom tenancy and two one-

bedroom tenancies.

“To be successful they need to be located next to good amenities like transport, shopping and coffee culture,” he says. “The most likely places for that to work in Brisbane are inner-city suburbs like Paddington, Wilston and Newmarket.”

Traps to avoid

Assuming you have a solid portfolio and the financial capacity to take on something like this, there are still a few pitfalls.

Bright says buyers of apartments need to remember that high management and strata fees can erode a yield that appears attractive at first.

“You can get properties with a straight yield of 7 per cent but the costs are so high. You make it in the rent and lose it in the maintenance costs of the building. That’s a typical catch that people get caught out in.”

Bright says corporate letting lacks the consistency of occupancy available from a normal tenancy. The management fees can sometimes be higher as well, and there will be more wear and tear and additional cleaning costs.

“By the time you add up all your costs, your overall outcome may not be significantly better. In some cases it will be a little better – when you can get \$650 instead of \$400 a week – but you won’t be able to pocket all of that extra \$250.

“You also need to be in a building where they allow it. In some buildings it’s disallowed by the body corporate – you can’t have tenancies of less than three months. So before you attempt something like that, you need to make sure the body corporate laws allow it.” ■

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