Conducting due diligence when buying **off the plan**

You have just found your dream investment property. The only problem: it doesn't exist yet. *Tim McIntyre* explains the due diligence required when buying off the plan

Property investors love numbers. It doesn't get much more satisfying than snapping up a house or unit for less than its value, renting it out for a good return and then sitting back while the compound growth machine clicks into gear.

Owner-occupiers on the other hand need more than this from a property. They want a place to be easy on the eyes, practical for their work and lifestyle requirements and in possession of a comforting home feel.

For these reasons, buying off the plan is probably easier for the former than the latter. It is hard to figure out if a place is just right for you when it is nothing more than a blueprint, council plan or artist's impression. The finished product can be a similar disappointment to when your favourite book is turned into a movie and the main character looks nothing like you imagined.

All you can really consider is whether or not the numbers stack up, how likely the developers are to deliver on their promises and whether the contract conditions are beneficial for your situation.

The pitch

Developers can be up against it when trying to sell properties off the plan. They need you to help them cover their up-front financial requirements and help ensure the project is a success. For this reason, getting in at the early stages of a development can be quite beneficial. Some of the positive points can include:

The best price

The first properties released usually go for the cheapest, because the developers need fast early sales. Once they meet their financial requirements, they often up the purchase price on the remaining properties to make up for lost profits.

Today's price for tomorrow's equity

An off-the-plan purchase means you can lock in the ownership of a property, without having to settle for an extended period of time. It may be one or two years before settlement, so capital growth can often make your initial deposit more valuable in the meantime. The risk here is that the value may decrease in this time, so it is important to be sure about the area, not just the property. If you intend to hold the property long term, value fluctuations in the immediate future may not overly concern you.

Time is on your side

The long settlement period means you have some breathing room to take care of the investment, or to organise to move house if you intend to be an owner-occupier. You can also use the time to save money and reduce the amount of finance you will need to borrow.

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Government incentives

New properties are all the rage at the moment, as far as state and territory governments are concerned. Most provide stamp duty concessions for brand-new properties, as they attempt to stimulate their economies through construction. The NSW Government has even replaced the $7,000 first home owner's grant with a $15,000 bonus for purchasers of brand-new properties.

Pick of the bunch

Getting in early allows you to choose your purchase from a range of properties within the development. You can grab the one with the best view, or that's furthest from a busy street. You don't usually have multiple options within the one specific location when buying an established property.

Doing your research

The benefits show that buying off the plan can be a strategy that works for many investors. Naturally, you have to do your regular research to ensure that the numbers work for you, including finance, return, growth potential, gearing, depreciation benefits and so on. In addition, the complex nature of an off-the-plan purchase means you should conduct a range of other checks to make sure the investment runs as smoothly as possible.

The don'ts of buying off the plan

Buyer's agent Cate Bakos, from Empower Wealth, says remember the following:

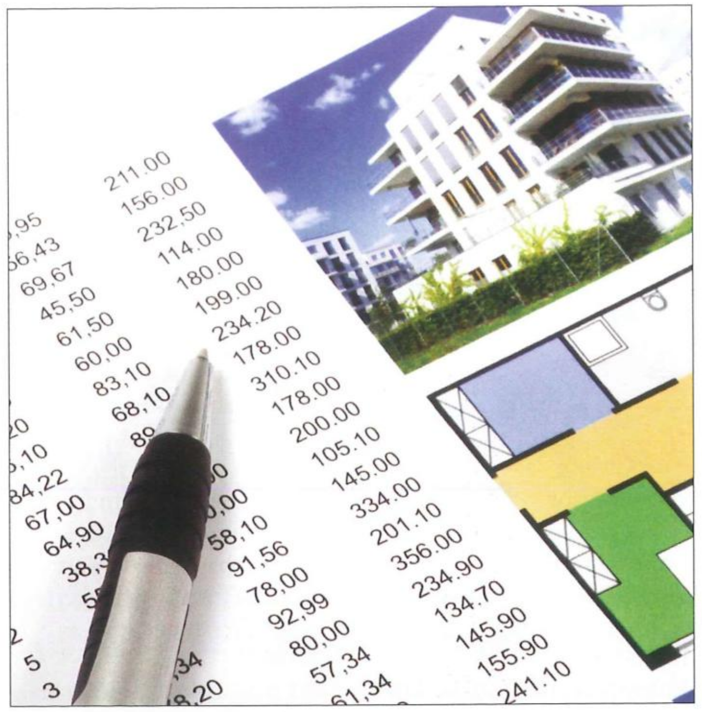
- ✗ Don't pay a price which exceeds value. Not only will you potentially face negative equity, you could face the lenders saying "no" to the property once they send a valuer through prior to settlement.
- ✗ Don't be lured into a 'rent-back' or 'rental guarantee'. Banks don't like them and in a lot of cases they are artificial. If the developer can afford to pay you a guaranteed 7% return for two years, you have probably paid for it in your purchase price.
- ✗ Don't be tempted to accept 'rebates'. It's a way that developers can artificially inflate contract prices to give the illusion that stock is selling for a higher price than it actually is. Not only is it wrong, it is illegal.
- ✗ Don't assume that the market will rise between now and a long-range settlement period. This is a dangerous assumption in an uncertain market.

Contract

Buying off the plan involves signing an off-the-plan contract of sale, which is drafted and tailored quite differently to a normal contract,' according to property law expert Despina Priala, principal of Priala Legal. She recommends that before signing, you seek legal advice from a contract and property law professional. Priala says it is essential to check that the following factors are included in your contract:

Cooling-off period if you change your mind

A cooling-off period of between three and five days applies to your contract in most states. This means you can change your mind about purchasing the property during this time. However, if you decide to withdraw during this



time you may be charged with a termination penalty by the developer (0.25% of purchase price). Once this period ends, you are legally bound to buy the property.

Adequate plan disclosure

In an off-the-plan contract you are provided with plans and specifications of what the developer intends to build and construct as the finished product. Usually, you will be given proposed plans yet to be approved by local council of the entire project, in addition to proposed floor plans of the particular property you have chosen, plus a schedule of finishes for the property (sometimes identifying a particular standard the developer has decided to use).

This is usually done prior to signing the contract of sale and discussed with the agent. It is very important you read and understand these plans before signing the contract to make sure you are satisfied with the level of disclosure the developer has provided to you and the detail and standard of the finishes. In the contract of sale, developers almost always retain the right to alter these plans if required to complete the project.

Deposit

Up to a maximum of 10% of the purchase price is payable and usually held in a legislated trust account and invested until settlement. Your contract should be checked to see who ends up with the interest earned on the investment at settlement, that is, the seller or buyer or both. Sometimes buyers are entitled to share in the interest earned.

Inclusions and warranties

The contract usually provides that the property will be constructed in accordance with the finishes and materials described in the contract, but it also provides the developer with the sole right to alter the finishes and materials in certain circumstances, provided the alternatives are of no less quality.

You should know that from start to finish, the developer is given a lot of flexibility in how the project is to be completed.

The developer can make changes, provided they will not materially prejudice you as the buyer. If the changes are prejudicial, you want a contract that allows you the right to withdraw and obtain your deposit back.

Review inclusions and warranties in the contract to ensure you are protected from prejudicial changes and to see whether you can make your own customised changes.

Top tip!

Seek an inclusion that allows you the right to on-sell the property, in case you decide to on-sell during its construction

Finance

If you require funding from a lender to complete your purchase, you need to ensure the contract is subject to you obtaining suitable finance within a certain time frame from when you sign. Usually, developers will agree to give buyers 14, 21 or even 30 days from when the contract is signed to obtain finance approval.

You will need to check with your financier that finance approval can be obtained early while the project is being completed. You also need to ensure you are adequately protected under the contract if you cannot obtain adequate funding and need to cancel the contract and obtain a refund of your deposit.

Defects

Normally, off-the-plan contracts provide that the developer is to remedy any defects identified by you as the buyer, prior to you settling on your purchase. Prior to settling, as the buyer you are given a right to pre-inspect the property and identify any defects to the developer.

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Stamp duty

Stamp duty must be paid on all purchase contracts. There are strict time periods involved and certain concessions and exemptions available to buyers of residential property.

There are certain conditions that must be met in order to gain these exemptions or concessions. You need to obtain appropriate legal advice early as to your stamp duty liabilities.

Completion

The contract will usually provide buyers with an estimated time of when the developer intends to complete the project. The developer is usually provided with flexibility to extend or alter these time frames whilst taking all reasonable steps to complete the project as quickly as possible. If the developer cannot complete the project within this time frame, then both the developer and the buyer can terminate the contract. In those circumstances, the deposit is refunded to the buyer.

Builder/developer

Before entering into a contract with a developer, do a background check.

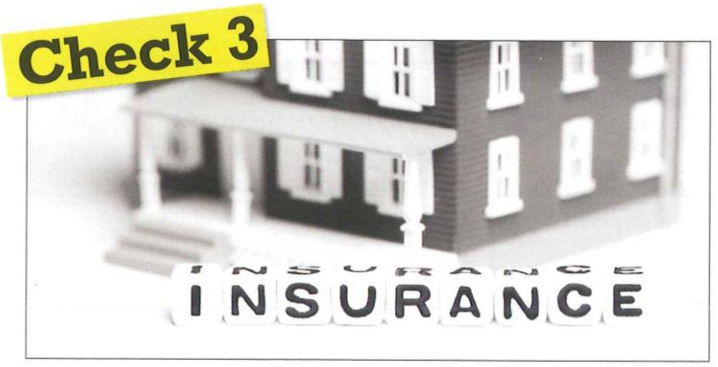
Start by visiting the company's website. You should be able to access information relating to past and present projects, as well as business numbers and contact details.

Then, utilise online forums to find out whether other investors have had positive or negative experiences with the same developer in the past.

Once satisfied, ask for the licence number of the builders used for the construction of the property. You can then do a licence check on any of the state government websites, to obtain information such as:

- Details about the licensee, including address, date of birth and the work they can do.
- The date of issue and expiry of the licence.
- Conditions endorsed on the licence.
- Names of partners in a partnership, or directors of a corporation.
- The results of any disciplinary determinations and prosecutions.
- The number of insurance claims paid in respect of work done by the holder.
- Details of penalty notices issued to the holder.
- Any cancellations or suspensions of the licence.

If the search turns up any concerning results, you may want to reconsider entering into a contract with the developer. A legal professional will also be able to advise you of other available checks.



Home warranty insurance

It is the developer's legal responsibility to provide home warranty insurance cover before entering into a contract for the sale of the off-the-plan property, provided the contract is for more than $20,000.

The insurance covers the owner of the property for loss or damage resulting from non-completion of work, loss of deposit, or breach of statutory warranty.

Residential buildings of more than three storeys in height are generally exempt from home warranty insurance cover, but construction of a multi-unit residential building of less than three-storeys (not including carpark) requires the developer to attach a home warranty insurance certificate to the contract for sale.

A certificate of home warranty insurance should be an original, issued by the insurer. It should feature the property's address, name of home owner, name of developer, name of insurer and total sum of the contract.

You should contact the insurer directly if unsure that the insurance certificate is valid.

Check 4

Financing the purchase

It can be tricky to have finance approved for an off-the-plan purchase and many investors end up losing their deposit after being unable to complete the deal.

Some lenders are reluctant because properties may be sold for more than they are worth, or in an uncertain market their values may decrease between the signing of the contract and the property's completion.

Some lenders protect themselves from possible loss by capping such loans at 80% LVR; while others will require later reviews of any pre-approvals they issue at the time you sign the contract. You want to be careful not to blemish your credit record with a loan rejection, so it is best to wait until the building is complete and settlement is less than six weeks away before applying for formal approval.

Banks such as Commonwealth, Westpac and Suncorp provide long-term loan approvals, which are subject to a conditional 'on completion' valuation, conducted 90 days before settlement. This enables them to ascertain that the value is stable and also to re-evaluate the applicant's financial situation.

NAB will also lend to off-the-plan purchasers on a case-by-case basis, but applications are only valid for 90 days, as per the bank's policy for all borrowers.

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Deposit bonds

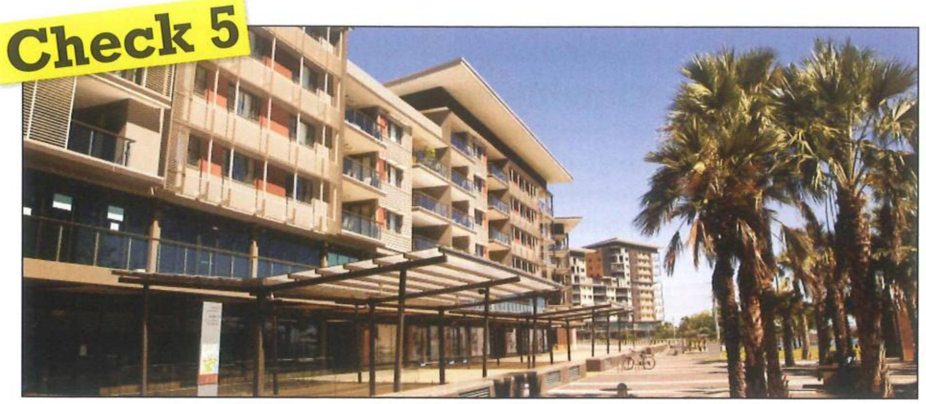
You may be able to use a deposit bond, in lieu of an actual deposit.

A deposit bond is essentially an insurance policy, featuring a policy document guaranteeing the vendor that the insurance company will pay the 10% deposit if you are unable to come through with the money. No money changes hands in this case and you can pay all purchase funds at the time of settlement.

The deposit bond will allow you to keep your savings intact or avoid bridging finance. Some can be used for up to four years, making them ideal for off-the-plan purchases. However, a developer needing cash to meet financial obligations is unlikely to accept a deposit bond; while real estate agents may not like it either, as they receive commission from deposits. It is therefore important that the use of a deposit bond is negotiated with the developer before the contract is signed.

You should remember that only the developer is covered by the bond. If the insurers have to pay it for whatever reason, they will seek compensation from you afterwards.

Check 5



The property and its suburb

Choose wisely

For most off-the-plans, it's first in, best dressed.

Penthouse apartments and others with the best views are often snapped up first and may go for more than the other properties within the development. It's a good to know what you want from your apartment. Questions include:

- Is it facing towards the nicest aspect?
- Is it removed from noise sources such as busy roads or workshops?
- Is its car space conveniently located?
- Is it as high or low in the building as you would like?

The right choice of apartment can make your purchase worth more than others in the same building, while actually costing the same amount. This maximises its potential for capital growth and rental yields.

Prime position

Naturally, there is no point picking the nicest apartment if it's in a suburb that is likely to stagnate. Your research on the area should be the same as if you were buying a property anywhere. Remember the following:

- An apartment in the development may seem cheap, but it may be over-valued compared to other properties in the suburb.
- You may have been promised a high rental yield, but this won't last if tenants find other properties with less rent.
- The suburb itself should have regular growth drivers such as good amenities, infrastructure, a favourable supply and demand ratio and be close to public transport.

The risks

Buyer's agent Cate Bakos, from Empower Wealth, has five good reasons to avoid off-the-plan properties:

They tend to be higher density: Given that land appreciates and buildings depreciate, you will find that as your glossy new apartment dates and ages, its value will be compromised.

Overcrowding: When one higher density block goes into a street or area, usually more follow. This can lead to an oversupply and issues such as overcrowded street parking, overshadowing and a higher proportion of tenants.

Similar assets: If a seller sells at a super-low price, it has a knock-on effect on the value of the other similar units.

Competition: The landlords go into competition with each other on a large scale when the block. is first released and settled. This can push down rents and push up vacancy rates.

The sales pitch: Developers are good at 'selling the dream'. In a lot of cases people pay over-inflated prices for units. Buyers assume that stamp duty savings are putting them in an advantageous position, but this benefit is eroded if they pay too much.