THAT COULD HARM YOUR INVESTMENT

How do you spot investment hazards that could derail your portfolio and what are the consequences if you neglect to check them? *Cate Bakos* explains

Deal-breaker is a strong word for any advisor or negotiator to use and I use it sparingly. However, there are five top roadblocks to any property investment success. I've defined each one, how I spot them and what the costs are if they are neglected or overlooked.

1 | COMPROMISED LOCATION

Buyers can look at a property creatively with the plan to add value, change a floor plan, improve with a cosmetic renovation, and even change the type of title on occasion. But what they can never change is a bad location (or proximity to something undesirable to live near).

Of all of my top five deal-breakers, this is probably the easiest one for the buyer to identify. All the investor has to do is put themselves in the shoes of a tenant and ask themselves if there is anything associated with the location or the surrounds which could deter them from wanting to live in the property themselves. Some of us may not be as sensitive as others to locations that bound main roads, train lines, freeways or have flight paths above. Others may not mind a factory or a cemetery next door – but if we can imagine a fussy tenant who has plenty of properties to choose from, this is probably the best tactic to apply when deciding how readily the property may rent or ultimately re-sell.

Mainstream occupants don't like noise, traffic congestion in their street, unsafe/unsecure properties, industrial smells, industrial vistas, quarrelsome neighbours or health risk areas nearby. A compromised location usually means that one or more of these risks are dominant.

Interestingly, tenants are generally less fussy than buyers – and sometimes investors will argue with me that they don't mind buying at a discounted price and dealing with the compromise.

What they fail to consider is that even if they never plan to sell the property, other nearby properties which are affected by the same detractors will fail to sell for strong prices and their asset's value will be underpinned by the other underperforming neighbouring properties.

We can change floor plans, landscaped yards, kitchens and bathrooms. We can change car accommodation and we can even change the external style of a property. We can't change a bad location.

2 | TOUGH ASSET TO OBTAIN FINANCE FOR

I am often quoted as saying "I don't like properties that the banks don't like". I do my best to secure assets that the banks would consider appealing and low risk. Banks refer to the property as 'security' because it is the asset that they can liquidate to cover their exposure in the event that a mortgagor stops paying the mortgage. A lender will be cautious about any asset [illegible]her risk of price [illegible]ownturn, and as such, the lender will apply its own scrutiny to that particular asset when the buyer produces a contract of sale and asks for a loan.

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Lender scrutiny includes valuer assessment, however it also commonly incudes other methods of scrutiny including 'risk rating' and referral to the lender's mortgage insurer. Mortgage insurers are often more restrictive than the lender in some cases, particularly when it comes to the property zoning and title type.

• A property with a non-strata title

For example, Stratum or Company Share are titles that are subject to further restriction when it comes to getting a loan. Mortgage insurers and lenders typically do not accept LVRs (loan to value ratios) of greater than 80% of the value for these types of properties. In some cases as low as 60% restrictions can apply. What this means is that if you're buying this type of property, you will need a 40% deposit plus purchase costs in order to get the finance.

• Differently zoned properties

Did you know that commercial zoning, industrial zoning, mixed use zoning and even residential zoned properties in clusters of commercial buildings can have similar restrictions applied to it?

This means that even if you're buying a residential property but if it's in a mixed zone area, the lender will assess it as with the others, ie commercial or industrial. The impact of this is that instead of being processed as residential purchase and get the corresponding rate, your lender might apply commercial lending rates to it.

There is a big difference between commercial and residential property when it comes to interest rate and lending policy.

When I was working as a mortgage broker, I had a client who had a residentially zoned property in Melbourne's popular Fitzroy. His single fronted Victorian terrace had a shop front window beside his front door, and despite the fact that his property zoning (and loan at the time) was residentially-based, the valuer deemed the property a commercial property and his eligibility for the loan I'd lodged evaporated.

• Risk-specific properties

Lender scrutiny isn't necessarily just title or zone specific. It is RISK specific. I once had a buyer apply for a loan in a location which was deemed 'postcode restricted' after the Black Saturday fires. The area had not been ravaged by fire, however the lender had added this suburb to their list of restricted locations.

The same applied for certain suburbs after the Queensland floods. I also recall a 'bargain' property which had been burnt out internally in part by a house fire. While the buyer was excited about her opportunity to have her tradespeople-family members help her rebuild the damaged section, the bank was not so excited. Her loan application was rejected on the basis that the house was fire damaged and posed a risk to the bank.

• High rise and off-the-plan properties

An important lesson I learnt while working as a mortgage broker was the bank's reluctance to take on exposure in high rise developments and many off-the-plan properties.

In one situation, a lender rejected a property in a high rise development because they had reached their own designated exposure to the block. In other words, some lenders will restrict the total number of any apartments which they will finance in a given block just to control their exposure to the development.

But more commonly, we find that lenders may not necessarily 'reject' a loan application for an off-the-plan purchase, but in many cases the valuation will come in significantly under purchase price. This can be a deal-breaker for many buyers, because they may find that they are unable to 'bridge' the gap with their own additional contributions above and beyond their desired deposit and purchase costs.

I recall a Gold Coast client's property which was purchased at $540,000 and valued at $370,000. My client had nowhere to go except a class action. Too often we read about 'lease-back guarantees', 'free furnishings', or 'free investment advice'. Nothing is free in this part of our industry – the buyer pays, and the lenders know it.

3 | MINIMAL TENANT APPEAL AND/OR DEMAND (HIGH VACANCY RATE)

I believe that there are four elements to a successful investment purchase:

- Rents and cash flows associated with the property do not exceed the investor's own surplus cash flow limits
- Capital growth drivers are strong and sustained
- Target tenant pool are desirable tenants who can pay their rent on time every time, and will keep the property in good condition, and
- The property does not attract vacancy

It is all well and good to purchase in an area where capital growth is strong and potential rent is acceptable, however if vacancy is affecting the suburb or the type of property in that suburb, the cash flows will place the investor into a financially uncomfortable situation.

Our major cities in Australia certainly all have suburbs where higher density developments are rife. These areas are tougher for investors to find a strong pool of good tenants because the brand new, glossy high rise apartments are cannibalising the older property's tenant pools.

In addition, landlords are competing with each other for tenants in the new release properties, and based on the properties all having very similar internal features, the only tool that can be applied in order to attract tenants is price discounting. This can have disastrous effects across a property type in any given suburb because every investor suffers.

The same concern can be applied to mining towns and fast-boom areas where infrastructure development is at a fast pace, yet hinging on just one main employer. Take Queensland's Gladstone for example; the area boomed rapidly and workers flocked to Gladstone during the height of the LNG project, yet when the major mining companies scaled back their project sights three years ago, rental demand fell through the floor and rents more than halved due to vacancy rates.

Vacancy threat cannot be underestimated and genuine reasons for tenants to rent need to be evident, not just one major employer.

4 | RESTRICTIVE CLAUSES IN THE CONTRACT

Provisions in the contract which prevent the purchaser from doing what they intended with the property is a big deal-breaker.

Many investors purchase with the dream of 'doing something' to the property; whether it be a clever subdivision, an exciting extension, installation of a new high fence, a facade make-over, or even a conversion of one type of property into another, for example converting a terrace house into a shopfront or office.

There are many restrictions that can apply to a property and will prevent the investor from achieving their main goal. Such restrictions can include:

• Overlays (From heritage to cultural significance just to name two)

Heritage overlays can be as specific as defining the paint colour that the house facade is to remain. Some overlays are less restrictive than others, but it pays to have the contract reviewed by a qualified legal practitioner so that the investor can have a better idea of any provisions which may adversely affect their plans for the property.

• Covenants

A covenant is specific and is on the title. It can range from managing a streetscape in a new estate for a large number of years, through to restricting a new buyer from ever building on the property. Covenants should never be taken lightly and all must be understood before purchasing.

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• Special conditions

Many vendors' legal representatives add Special Conditions into the contract. Typically they relate to settlement and financial matters but often they will relate to the subdivision, previous ownership arrangements or even arrangements which have been struck with neighbours. They must be understood (and challenged if need be) BEFORE signing a contract.

• Zoning and/or council restrictions

These limitations can prevent a property from being occupied by a resident in some cases.

A legal review will shed light on all of these elements and for a minimal cost (when compared to the potential purchase cost), a buyer is crazy to buy without a review beforehand. As a buyer's advocate and qualified property investment advisor, I never let a client sign a contract without an independent legal review at the very least.

5 | NEGATIVE CASH FLOWS WHICH EXCEED THE PURCHASER'S BUDGET

This is sometimes the toughest deal-breaker to spot. A property's cash flow can be calculated readily enough. I've seen many a robust cash flow spreadsheet; and I use them myself, however there are some cash flow items that can't be identified or guaranteed. These include outgoings; and often strata-related outgoings.

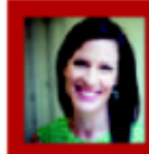
Most contracts will clearly state the owners' corporation fees applicable to a property. While they may be current, there are sometimes clues that these 'set fees' are about to change.

One such clue is the mention of significant items to be addressed in the owners' corporation AGM minutes. The issues may include roof repair, major upgrades to the building, asbestos removal, engineer's reports and subsidence cracking, major leaks, concrete reinforcement issues in basements, etc. I've seen many.

Make sure you do further due diligence. Calling the manager of the owners' corporations can help you glean more information and you can make provision if the property is still scoring highly as an investment. However, it is often the unknown owners' corporation costs that can create a deal-breaker for the investor.

Often for new properties (and typically high-density new properties including off-the-plan), the actual future outgoings are unknown. This information can be hazy or non-existent in some contracts for brand new properties.

I have seen cases where the eventual owners' corporation fees have exceeded $5,000 per year. In one high-rise case the outgoings were $12,000 per year. If an investor hasn't factored in the likely cost of the elevator maintenance, gym/pool insurance and maintenance, gardening, window cleaning and ongoing painting, they may not be able



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to afford to hold the property.

While every set of fees can be subject to change, it is prudent to recognise the items that are more likely to attract higher maintenance costs (ie elevators, undercroft parking and pools), and the buyer should make themselves aware of the condition of the building if buying an older property.

IN SHORT

What all of these deal-breakers have in common is the advantage and visibility any buyer has when they do their due diligence. Legal professionals, building inspectors, banking professionals and town planners are among a few who can help guide investors through this maze. ■

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