

## April 2007 Newsletter

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### **\$715,000 after-tax cash profit without investing a cent of your own money!**

Most investment properties are cash flow negative for the first few years of ownership. That is, the rental income received is not enough to cover all of the property's expenses (especially interest which is the largest expense). This turns some people off investing in property, because they do not necessarily want to commit to meeting a cash flow deficit every month from other income. Well, you don't have to. There is a solution that is worth considering. I will show you how to structure your loans so that the investment property ends up paying for itself. You don't have to use any other income to support the property. Best of all, you could use almost any lender to do this. It does not require any "special" or expensive loan products. The skill is in the structuring.

#### What's wrong with negative cash flow?

Some people choose not to invest in property, solely because of the need to commit to meeting a negative cash flow each month. There can be a number of reasons for this. For example, they might be in a high expense stage of life (e.g. paying for private school fees), or they might feel more comfortable if they are channelling all their spare cash flow into their home loan to eliminate it before commencing with any investing.

#### Eliminating the negative cash flow – the loan structure

Perhaps the loan structure is best explained by an example. Assume that an investor owns his home which is worth \$800,000 and has a home loan for \$300,000 (therefore he has equity of \$500,000). The investor purchases a \$400,000 investment property and borrows the full cost including stamp duty and legal fees.

Using investment property software (I used PIA),

I have forecast that the after tax negative cash flow (cost) produced by the property is just under \$200 per week in the first year. The annual property expenses (such as property management, insurance, etc. but excluding interest) are estimated to be approximately \$4,200 or \$80 per week. Therefore, the \$200 weekly negative cash flow is made up of \$80 of property expenses and the rest (i.e. \$120) in loan interest. This negative cash flow may reduce each year as the property's value increases as does the rental income (whereas expenses and interest are relatively fixed). The property produces a negative cash flow for the first 14 years as illustrated in the table below.

Year	Total after tax negative cash flow p.a.	After tax negative cash flow made up of:	
		Property ex-penses	Interest
1	\$10,314	\$4,198	\$6,116
2	\$9,318	\$4,282	\$5,036
3	\$8,952	\$4,368	\$4,584
4	\$8,632	\$4,455	\$4,177
5	\$8,185	\$4,544	\$3,641
6	\$7,640	\$4,635	\$3,005
7	\$7,012	\$4,728	\$2,284
8	\$6,309	\$4,822	\$1,487
9	\$5,536	\$4,919	\$617
10	\$4,694	\$4,694	\$0
11	\$3,780	\$3,780	\$0
12	\$2,794	\$2,794	\$0
13	\$1,732	\$1,732	\$0
14	\$587	\$587	\$0
15	<i>Positive cash flow after year 14</i>		
<b>Total</b>	<b>\$85,485</b>	<b>\$54,538</b>	<b>\$30,947</b>

In order to finance this purchase, we set up three loans, being:

1. Interest only loan for \$320,000 secured by

the new investment property only.

2. A line of credit for \$160,000 secured by the investor's home only.
3. A line of credit for \$70,000 secured by the investor's home only.

Loan 1 is used to finance 80% of the investment property's purchase price. Loan 2 is used to finance the remaining 20% plus the acquisition costs such as stamp duty and legal fees. Loan 2 will also be used to finance the expenses portion of the negative cash flow (e.g. \$4,198 in the first year – refer table above). Loan 3 will be used to finance the interest portion of the negative cash flow (e.g. \$6,116 in the first year).

The reason that we are using two separate loans (i.e. loans 2 and 3) to finance the negative cash flow is that the interest on loan 3 will not be tax deductible. The reason for this is that the ATO has directed that interest incurred on a loan that was used to pay interest is not deductible. Loan 3 will be used to finance the interest portion of the negative cash flow and no repayments will be made on this loan. Therefore, the balance will increase each year (as interest is added to the loan). By the end of year 14 the balance of this loan will be just under \$70,000 (because interest has accumulated over a 14 year period). The property produces a positive cash flow after year 14 and this will be used to start repaying loan 3. I estimate that by year 25, the (non-deductible) \$70,000 loan should be fully repaid. Of course, once the investor has finished repaying his home loan, he can start repaying the \$70,000 loan if he prefers to expedite this process.

At the end of 25 years, the investor will be left with two deductible loans for \$320,000 and \$160,000. The property should be worth just over \$2.7 million. The investor can sell the property and walk away with over \$1.5 million in cash in the bank (net of selling costs, GST and after repaying the two loans).

Therefore, I have shown you how to create \$1.5 million of wealth (cash) in 25 years without having to contribute a cent of your income or cash savings. Assuming an average inflation rate of 3% per year, \$1.5 million in 25 years is equivalent to over \$715,000 in today's dollars. A handsome profit! Alternatively, the investor can retain the property and enjoy a pre-tax cash flow of approximately \$42,000 per year.

If the investor had sold the property after 15 years (i.e. after a shorter time frame – some people may not want to wait 25 years), he could have walked away with over \$470,000 in cash.

### Minimise the negative cash flow

Using further debt to finance a negative cash flow (as described above) does not sit well with some people, which I can understand. However, the numbers justify the strategy (i.e. it creates significant wealth) and a person is better off to use this strategy as opposed to not investing at all. However, there might be some middle ground. One variation could include using Loan 2 to pay for the expense portion of the negative cash flow and paying the interest portion each week (from other income such as salary). The benefit of doing this is you do not end up accumulating non-deductible debt (i.e. \$70,000 in 14 years). It also reduces the cash flow commitment from approximately \$200 per week to just under \$120 per week on the first year (it will reduce to under \$100 in the second year and so on).

This is a good option for people with a home loan because it will allow you to divert as much income into your home loan as possible.

### Equity = opportunity

Obviously, to initiate this strategy, you must have sufficient equity in your existing property/s. Equity is a tremendous asset because it gives you the opportunity to invest without you needing to contribute any cash. Some people could be sitting on a mountain of "opportunity" and not even know it. Putting it another way, some people could be wasting a great opportunity (i.e. those that have plenty of equity) to create tremendous wealth just because they don't know how to do it (or it will cost them money).

### But you may never end up using this structure

You may regard this loan structure as a safety net only. Your major concern with purchasing an investment property might be needing to reduce the amount of cash you spend elsewhere (e.g. schooling, holidays, etc), in order to support the negative cash flow the property generates. You may not want to be put in that position, so you opt not to invest. This loan structure provides you

with choices. This structure means you may never have to adjust your current standard of living, because the loan will finance the negative cash flow. That said, curbing discretionary expenditure so you can contribute to investments is always a good idea!

### Asset selection is so critical

I cannot stress enough how important asset selection is. You need to be investing in the highest quality assets so that you can maximise the chances of enjoying strong capital growth. Asset selection is even more critical when you are using a loan to fund the negative cash flow, because you want the property's value to increase significantly more than your outstanding loan balance increases, to make it worthwhile. In my calculations, I have used an average capital growth rate of 8%. Anyone that invests in property should be aiming to achieve a growth rate of at least 8%. A 1% reduction in capital growth (i.e. down to 7%) results in a reduction in property value by \$316,000 by year 20. However, an increase in capital growth rate by 1% (to 9%) results in an increase in the property's value by \$378,000 by year 20. Therefore, in my opinion, you really should seek professional advice (or at least a second opinion) from a professional investment property advisor, before making an acquisition. With so much potential wealth on the line, you would be silly not to.



### Risks - never borrow more than you can afford!

I want to be absolutely crystal clear! I am not suggesting that you borrow more than you can afford to repay. Doing so is foolish and invites financial hardship, so I want to make it absolutely certain that I am not, by any stretch of the imagination, suggesting you establish this loan structure because you could not otherwise afford the repayments. I am suggesting this loan structure to people that can afford to make the interest repayments, but choose not to - maybe because they prefer to repay their home loan, or

feel more comfortable not having to commit to paying for a cash flow deficit.

This strategy is not without risks. The three main risks are interest rate increases, a depressed rental market (i.e. no rental growth) and low capital growth (which we discussed above). The interest rate risk can be addressed by fixing the interest rate on most of the debt. I have assumed a 2% vacancy rate in my forecasts. However, it is possible that your rental income may not increase in line with the property's value. Selecting a top quality property and engaging a professional property manager will minimise this risk. The only way to address this risk is to build a buffer into the loan, to allow for a potentially larger negative cash flow.

### Maybe not for everyone... but

Investing in property is not for everyone. Furthermore, borrowing 100% of the cost of the property and then borrowing the negative cash flow may also be seen as "risky". However, I think it's not really as risky as it might first appear. In addition, if it allows you to invest in property sooner rather than later, then it's a great solution (and far better than not investing at all).

## Interest in Advance

We are endeavoring to negotiate a special offer for an interest in advance product. If you are interested in one of these products, then please look out for our announcement in early May.

## Our Best Interest Rates

Basic variable	7.24%
Offset	7.30% (0.77% ongoing disc.)
Offset (> \$500k)	7.27% (0.80% ongoing disc.)
Offset (> \$1 million)	7.17% (0.90% ongoing disc.)
1 year fixed	6.65%
2 years fixed	7.25%
3 years fixed	7.19%
4 years fixed	7.19%
5 years fixed	7.15%
10 years fixed	7.15%

Above rates are current as at 12/4/07 and are subject to change without notice. Standard lenders terms and conditions apply. Comparison rates are available upon request.