

RENT OR BUY?

An investor's viewpoint

Which is better, renting your home or buying it? It's a topic that's been discussed ad nauseam, but as accountant **Stuart Wemyss** found out, there are some important considerations specific to property investors which need to be considered.

I WAS recently asked for my views on the 'rent versus buy' question. I sat down and prepared a spreadsheet which compared the two options, like a typical accountant! There are some important assumptions used in this calculation, including:

- I prepared the comparison over a five-year period. Holding a property for less than five years isn't generally viable, because of the large transactional costs such as stamp duty and selling costs.
- I assumed the mortgage interest rate was 7 per cent. According to the Reserve Bank of Australia, the standard variable rate over the past 10 years has fluctuated between 6 per cent and 8 per cent. Therefore, 7 per cent is the midpoint.
- The buyer borrowed 80 per cent of the property's purchase price to avoid the cost of mortgage insurance (therefore, they had a deposit of 20 per cent plus costs).
- The renter had to pay a rental yield of 3.6 per cent (therefore, rent payable on a property worth \$400,000 is \$14,400 per year, or \$277 per week).
- The renter is able to earn an interest rate of 6 per cent on any savings deposited in a bank (i.e. the money they would have used as a deposit).

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■ The renter saves the difference between the potential mortgage repayments (principal and interest) and the lower rental cost. For example, if the renter bought a \$400,000 property, the monthly mortgage repayments would be \$2130. However, renting a \$400,000 property would cost \$1215 a month. Therefore, I assumed that the renter saved \$915 per month (\$2130 less \$1215). This is a really important assumption. More about this later.

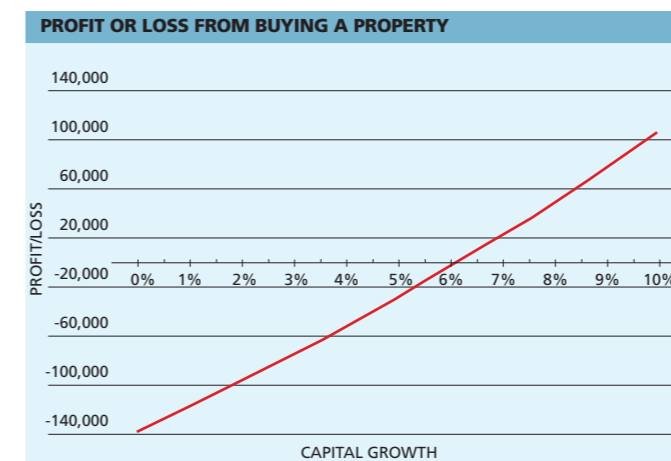
The results

What my calculations revealed was that the key variable was capital growth, which is the amount or rate at which the property's value would increase. I worked out that if you're buying a home and you expect the capital growth to exceed 6.4 per cent per annum (on average over a five-year period), then you'll be better off buying that home rather than renting it. Therefore, in my opinion, the key question to ask yourself if you're thinking of buying a home is, what capital growth can I expect if I buy the type of property I want (i.e. house, apartment, etc.) in the area I want to live in? If you think the average capital growth over the next five years will be less than 6.4 per cent per annum, then you're better off renting in the same area and not buying.

I based my calculations on the assumption that the buyer would borrow 80 per cent of the property's value. However, if you need to borrow a higher percentage of the property's value, say 95 per cent, then that capital growth rate needs to exceed 7.6 per cent for you to be better off buying rather than renting.

The higher the purchase price, the higher the capital growth rate needs to be. I based my numbers on a purchase for \$400,000. However, if you're spending \$800,000 on a property purchase, the capital growth rate needs to exceed 7.9 per cent for you to be better off buying. If you're spending \$1.2 million, the capital growth rate needs to exceed 8.4 per cent and at \$1.5 million, the rate needs to exceed 8.6 per cent.

The graph below illustrates the relationship between the profit or loss from buying a home compared to renting and the property's capital growth rate. You can see that approximately 6.4 per cent is the breakeven point.



Some renters fall into the trap of spending the cash flow saving on their "lifestyle". This is a common trap and is extremely "wealth destroying".

Achieving capital growth above 6.4 per cent to 8 per cent

Many people reading this article may think property prices will be pretty stable over the next few years. From that, they may deduce that they should rent and not buy. However, their opinions may have been incorrectly influenced by "average" property price data and media hype. It's very important to understand that the property market is very fragmented.

While property values overall may remain steady, values in some suburbs will increase and values in other suburbs will decrease. In fact, certain streets within a suburb may outperform the suburb as a whole and other streets will underperform the suburb. Therefore, concluding that "because property values are expected to be flat across the board it's not a good time to buy property" is ill informed. You need to research the particular area where you'd like to live.

Monique Wakelin, director of Wakelin Property Advisory, suggests investors should aim to achieve a long-term average capital growth rate of 5 per cent to 8 per cent in excess of inflation. The inflation rate is currently around the 3 per cent mark. Therefore, Wakelin believes property purchasers should be able to achieve a nominal (long-term) capital growth rate of 8 per cent to 11 per cent.

"Astute purchasers should be able to generate strong capital growth by selecting a quality asset that exhibits scarcity value," says Wakelin.

Cash flow and borrowing capacity difference

From a cash flow perspective, renting may be a lot cheaper, especially for people with little equity or no deposit. Consider the example of two people who occupy a property worth \$500,000. The renter will probably pay a rental yield of say 3.5 per cent, depending on location. This amounts to an annual cash outflow of \$17,500.

Assume the homeowner has a home loan of \$400,000. Annual principal and interest repayments on this loan will be about \$32,000. Therefore, the homeowner's annual commitments are \$14,500 higher than the renter (\$32,000 less \$17,500).

The renter can borrow over \$220,000 more than the

homebuyer because of this commitment difference (and also the fact that banks factor potential interest rate increases into their borrowing capacity calculations, which affects the homebuyer but not the renter). The homeowner's loan would need to be less than \$220,000 for the repayments to be less than the renter's annual commitment of \$17,500. The conclusion is, if you have little cash or equity, then you may be better off maximising your borrowing capacity by renting rather than buying a home so that you can purchase more investment properties.

Deposit power

Investors should understand that owning your home may render some of your cash or equity to be unusable. Perhaps the best way to communicate this point is to consider an example.

Consider two different investors. One investor has

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\$200,000 of equity in his home (say a home worth \$400,000 with an outstanding mortgage of \$200,000) and another doesn't own a home but has \$200,000 in cash.

The investor with \$200,000 cash can buy about \$800,000 of property (note, this figure will depend on the state the property is bought in as stamp duty charges vary), assuming a maximum loan to value ratio of 80 per cent is maintained (i.e. the \$200,000 cash was used to pay for a 20 per cent deposit plus costs).

The investor who owns his home can borrow up to 80 per cent of his home's value (therefore, \$320,000). He already has a \$200,000 home loan secured by this property. Therefore, he can borrow an extra \$120,000. This amount (\$120,000) can be used to pay for a 20 per cent deposit plus costs (eg. stamp duty). Therefore, this investor can spend up to \$480,000 on an investment property while maintaining the loan to value ratio of 80 per cent.

In these calculations, I've assumed that the investor borrows a maximum of 80 per cent of the property's value. This is the maximum most lenders will provide without charging Lender Mortgage Insurance, which can be a very costly upfront fee. However, it's possible for the homeowner to bridge some of this gap between him or herself and the cash holder by borrowing more than 80 per cent (although, as noted, this does come at a cost). This leads nicely into my next point about timing.

The timing issue

Most people intend to own a home some time in their life. Therefore, some investors are faced with the decision: "What do I buy first? A home or an investment property?" I

would guess that there would be very few people who would decide never to purchase a home just because the numbers don't stack up.

Buying a home and then an investment property

The main advantage with this strategy is that it allows you to balance your tax deductible and non-tax deductible debt more effectively. That is, you're able to contribute all your cash towards your home purchase to minimise your non-tax deductible home loan. You can then utilise the equity in your home to borrow the total cost of your investment property, even if it means paying for mortgage insurance. The main practical downside to this strategy is that for many people, the subsequent investment property purchase may never eventuate. They may have every intention to purchase an investment property. However, due to constant distractions in life, time slips away and

they may never actually complete the investment property purchase. In this situation, they would have been far better off purchasing the investment property before the home from a wealth-building perspective. So, if you choose this strategy, make sure you follow through with your intentions and purchase investment property.

Buying an investment property first and then a home

Obviously the reverse of the pros and cons mentioned above apply to this strategy. Another benefit of this strategy is that buying an investment property a number of years before you buy a home may help you afford to purchase a more expensive home as you would have hopefully built up some equity in your investment property.

Occupying an investment property

A really good "happy medium" is to purchase a property purely on investment fundamentals (i.e. purchase the property as if you weren't going to live in it) and then occupy the property as your home. Of course, this may involve you having to compromise on your personal lifestyle requirements. However, the main benefit is that you won't compromise on the main reason for investing in property. That is, capital growth! You will, of course, be missing out on the income (i.e. rent). However, it's capital growth that will increase your net wealth the most and allow you to continue to build your property portfolio.

The biggest downside to buying a home is that home purchases are heavily influenced by personal, non-financial preferences (eg. the location, type of architecture, etc.). This

may result in someone purchasing a poor quality asset from an investment perspective, whereas investment property purchases should be unemotional and only influenced by the question "which asset is going to perform the best?".

Therefore, eliminating the "emotional" influences from your home purchase should go a long way to helping you build your wealth!

This strategy is particularly important for people who may only want to buy a home to occupy for a short period (say five years). Buying a good quality asset can help them tremendously after they decide not to occupy the home anymore and sell it or rent it out.

Buying: a forced savings plan

One risk to taking the "rent a home and buy an investment property" option is procrastination. Buying a property, be it a home or an investment, is a bit like a forced savings plan.

As discussed earlier, it's cheaper to rent a property from a cash flow perspective (i.e. rent payments are lower than home loan repayments). That can be useful as long as you use the cash flow saving wisely (eg. buying an investment property). However, some renters fall into the trap of spending the cash flow saving on their "lifestyle". This is a common trap and is extremely "wealth destroying".

By buying a property, you're essentially forced to contribute a greater proportion of your income towards buying an asset, rather than spending this money on your lifestyle. Therefore, if you're not as disciplined with your money as you could be, make sure you have something in place to "force" you to buy an investment property (a good solution is to use a buyers agent to locate and purchase the investment property for you, because then you know it will definitely be done).

Focusing on the financials

I've written this article on the basis that people are focused solely on the financial pros and cons. I realise this isn't realistic. I understand some people are mainly driven by personal preferences. For example, some people feel more secure if they own their home and would never want to rent. Some people prefer to rent near the city, because if they purchased, they could only afford to buy something in the outer suburbs and they aren't prepared to compromise on location.

The only advice I have for people who are heavily influenced by their "personal preferences" is to be aware of the financial repercussions of your decisions and how they may affect your long-term wealth because they can be absolutely huge! The renting or buying decision is not an easy choice to make. ■

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