Unlimited finance...

Fact or fiction?

BY STUART WEMYSS

Unlimited finance wouldn't that be nice! Many of us have been to the seminars, seen the websites and read the newspaper ads. Use a company or trust structure. Only buy high yielding properties. Use vendor-financing (or wrap) techniques. One of the ads I read recently said *"How to leverage your bank by 20 times! Got $5,000? You'll discover how to invest $100,000..."*

So what's the answer? Is there such a thing as unlimited finance? If so, how is it achieved? And is it even desirable?

The purpose of this article is to look at what factors cause investors to hit 'borrowing limits' that temporarily or permanently prevent them from accessing finance to acquire more properties. It's important to understand how some investors seem to be able to continue adding properties to their portfolios, while others find their property acquisition strategy grinds to an abrupt halt as their ability to source finance is exhausted.

BORROWING CAPACITY

To understand if unlimited finance is possible we first need to understand what factors can affect our borrowing capacity. Borrowing capacity is impacted by three key factors:

1. Income and expenses (known as serviceability).
2. Assets and liabilities (known as security).
3. Your borrowing history (referred to as credit worthiness).

SERVICEABILITY

Obviously to borrow money, you need to be able to demonstrate to the lender that you earn a stable and sufficient income to comfortably repay the loan. You don't need to earn a six-figure salary to be able to afford an investment property. You just need enough money to cover your personal financial commitments, the investment property loan plus a small buffer. Personal financial commitments include living expenses for you and your family, rent or existing home loan repayments, credit cards, etc. The 'buffer' will provide the lender with comfort that if one of your investment properties becomes vacant or if interest rates increase then you have the surplus capacity to still meet the loan repayments.

When banks assess a loan application, they calculate the dollar value of the principal and interest repayments using a benchmark interest rate regardless of how you elect to repay the loan (which is a fixed margin above the standard variable rate) and they compare this amount to the assessed rental income.

Assessed rental income is based on a percentage of the gross estimated rental income (normally in the range of 75% to 100%). The average gross rental income included in this assessment (from a review of over 18 lenders) is 80%. The rental income is reduced to take account of the expenses associated with the investment property (e.g. property management, maintenance, etc.) and the vacancy risk.

GETTY IMAGES

The average interest rate margin (added to the standard variable rate) is 1.5% from a review of the same lenders. Therefore, the average benchmark interest rate is approximately 8%. Perhaps this is explained better by an example.

Assume a property is valued at $100,000 with a rental yield of 9%. The investor contributed $20,000 (plus costs) in cash towards the purchase. The remaining value was financed by a mortgage (i.e. $80,000). Therefore, the assessed rental income would be equal to 80% of the estimated 9% yield ($100,000 x 9% x 80%), which equals $7,200 per annum. This would be compared to the assessed loan repayments on $80,000 at the benchmark rate of 8%, which equals $7,056 per annum. Therefore, this application has an assessed surplus of $144 ($7,200 -$7,056).

In this case the property is supporting the loan without requiring any income support from the borrower. In fact, in this case, the property would actually have the effect of marginally increasing the owner's borrowing capacity, because it adds an extra $144 of net income to the borrower's finance position.

So what rental yield is required to ensure that the investment property is not 'draining' your borrowing capacity?

If you finance your properties at 80% (that is, you actually only borrow 80% of the purchase price) then you need to achieve an average rental yield of 8.82% to ensure that purchasing the property does not affect your borrowing capacity. Or to put it another way, you need an average rental yield of 8.82% to achieve unlimited finance status.

However, if you finance your properties by borrowing 100% then you need an average rental yield of over 11%. In fact, you need an even higher rental yield if you're financing the costs (e.g. stamp duty) as well.

If your investment portfolio's yield is less than these rates, then I'm sorry to say that you will not be able to achieve unlimited finance... eventually you'll hit a serviceability limit.

One thing to consider is that there are lenders that will take into account up to 100% of estimated investment property rental income. There are also other lenders that use a benchmark interest rate of less than 8% when assessing loan applications. Investors who have weaker average gross rental yields might consider searching for these lenders. These lenders may not have the most competitive products, but they may allow borrower's to continue building their investment portfolios. After all, as an investor, which would you prefer? Saving 0.30% in interest or buying unlimited property?

So is it possible to have a property portfolio with an average rental yield of over 8.82%? This is a question for the positive cash flow investment property experts out there. However, I can confirm that one of my clients has achieved this. This client has accumulated 19 properties and his average rental yield is approximately 11%! So it's possible.

But don't throw in your job just yet. A lender will generally prefer that borrower's have two sources of income so that a borrower is not too – as they would term it – "rent reliant."

Borrowers should always consider their interest rate exposure and the effect of a rental market downturn. You need to have a sufficient buffer to weather a shrinking rental market. Plus, don't forget you need sufficient income to cover your personal financial commitments.

SECURITY

So now we know now that our average rental yield needs to be over 8.82% (or 11% if fully financed) to generate unlimited borrowing capacity. But how does security (equity or deposit) affect us?

It comes as no surprise that a lender would like adequate security to cover the loan. Should you default on your mortgage and cause the lender to take possession and sell the property. If they do sell the property, they need to be able to realise sufficient money to pay out the remaining debt. So what does this mean? Well, you need to have enough money (or equity in your property) to be able to contribute to the investment.

Most investors choose not borrow any more than 80% of the total value of their property. One reason for this is to ensure that they do not have to pay for Lenders Mortgage Insurance ("LMI"). LMI is a one-off cost that a borrower must pay at the beginning of the loan which insurers the lender's risk (not the borrower's) if a shortfall arises between the sales proceeds and the loan amount (that is, if the lender ever has to take possession and sell your property). Mortgage insurance can cost in the range of 1% to 3% of the loan amount, which is substantial if you're borrowing a large amount of money.

One of the other advantages of avoiding LMI is that a mortgage insurer does not have to approve your application. Mortgage insurers' credit policies are often much tighter and stricter than lenders' because they're accepting a high risk by lending at a higher loan-to-value ratio, or LVR.

Obviously investors must weigh up the pros and cons of purchasing now and borrowing over 80% with purchasing later and saving more deposit. The cost of mortgage insurance can easily be offset by capital appreciation in a fast moving market... assuming the property delivers the capital gains you expect, and your financial circumstances are strong enough that you're not over-geared at the higher gearing rates.

Most people think it's their income that will limit them buying more property... the 'serviceability barrier.' But this is not always correct because as we've learned, investors can increase (or at least maintain) their borrowing capacity by purchasing high yielding properties. Therefore, generally it's the security issue that poses the biggest hurdle to ongoing property purchases.

So what can investors do to create more equity? There are several major ways to increase your equity:

1. Contribute more cash.
2. Buying high capital growth properties (but these often drain serviceability).
3. Create instant equity by improving a property.
4. Vendor finance techniques.
5. Borrow the deposit from private lenders or other sources (subject to serviceability).

BORROWING HISTORY

Having a good borrowing history is as simple as paying your bills and loan repayments on time and not having any defaults recorded on your credit file. Be careful... telecommunication and utility companies are sometimes very quick to record a "default" if you don't pay your bill on time.

Every time you apply for credit (loan, credit card, etc.) the credit providers may undertake a credit check, or as it's often referred to, a credit enquiry. Credit enquiries are recorded on your credit record. Some lenders may decline to lend to you if you have too many credit enquiries on your credit file. So if you apply for a pre-approval for your next investment property, you might consider asking the lender not to do a credit check until you're absolutely sure that you will go through with the finance.

BORROWING THROUGH A COMPANY/TRUST SOLVES ALL... NOT

I've heard some property gurus suggest that borrowing through a trust (or company) increases your borrowing capacity. In this situation the trust will be the sole applicant on the mortgage. The gurus suggest you borrow through the trust until you've fully utilised its borrowing capacity, and then go and set up a new trust and repeat the process.

Does this seem reasonable? If you were a lender, would you lend unlimited amounts of money to a new company that has no other income stream except rental income? Changing your structure and introducing a company or trust structure does not change your capacity to service debt. You still have the same asset base and income. So why would setting up a company/trust matter?

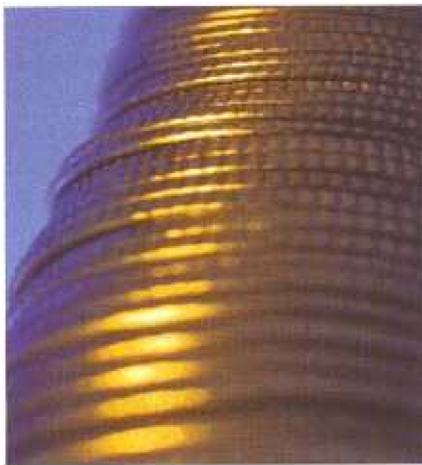
All lenders will generally require a personal guarantee from the trustee (or the directors of the trustee company, where applicable) or director of the company. Therefore there's not much difference in borrowing capacity between borrowing personally or through your own company or trust.

GUARANTEES LOWER BORROWING CAPACITY...

Some people are under the misconception that providing a guarantee does not affect your personal borrowing capacity. By providing a guarantee, you're essentially promising that you will meet all mortgage obligations should the borrowing entity (i.e. the Trust or Company) not fulfil these requirements.

When assessing the strength of a guarantee, the lender will consider the strength of a guarantor, including creditworthiness and financial position.

This financial position assessment will include an assessment of actual and contingent (such as other guarantees) financial commitments. A lender needs to satisfy itself that should the applicant not fulfil its obligations, the guarantor has the financial capacity to fulfil all mortgage obligations on behalf of the applicant. The lender will therefore complete the same detailed credit assessment for guarantors as it will for the applicants themselves.



DON'T THROW IN YOUR JOB JUST YET. A LENDER WILL GENERALLY PREFER BORROWERS TO HAVE TWO SOURCES OF INCOME SO THAT A BORROWER IS NOT TOO "RENT RELIANT."

Therefore, in my opinion, from a borrowing capacity perspective there's no real advantage to be gained by borrowing through a trust or company structure where a guarantee is provided.

Lenders will be able to find out about the guarantee that you've provided through a credit check. Guarantees are recorded on your credit file.

If you can find a lender that will lend money to a non-trading company/trust and not require a guarantee, then you've found unlimited finance. There are some private lenders that will do this, but expect exorbitant interest rates and lower loan to value ratios.

Borrowing through a trust or company structure may also have important tax and legal consequences, so professional advice should always be sought on these potentially complex issues.

DO YOU REALLY WANT UNLIMITED FINANCE?

In terms of financial risk, many Australians consider 'bricks and mortar' to be a much safer investment than typically more volatile asset classes such as shares. However, when property investors do get into financial trouble, it's often because they've borrowed too heavily and over-geared themselves.

It's absolutely critical that both new and experienced investors be aware of their interest rate exposure and associated risks. Interest rates certainly won't stay this low forever.

I've heard some people argue "the property pays for the loan so I don't know what the lender's concern is."

Yes, that may be the case at the moment, but what happens when your property becomes vacant? What happens if interest rates rise by 2%... or more? Remember, your loan contract is 25 to 30 years. Interest rates might be low now but what happens if (or should I say when) they do rise? After all, the last thing you want is to be put into a position where you're forced to sell the property.

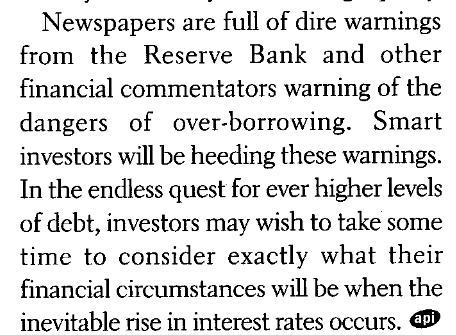
UNLIMITED FINANCE... FICTION

So what do we know? We know that serviceability and security have the greatest impact on borrowing capacity. We also know that we need to attain an average rental yield in the range of 8.8% to 11% to ensure unlimited finance. We also need unlimited equity to be able to secure this debt.

It's very important for investors to be able to understand what impacts borrowing capacity. Investors may need to consider these factors when planning their property investment strategy, as their investment strategy will have an impact on their borrowing capacity.

You need to ask yourself how your strategy will affect your borrowing capacity. For example, if you plan to buy a number of low yielding properties (perhaps in the expectation of high capital gains down the track), then it's very likely that you'll limit your borrowing capacity. Eventually you'll reach the limits of your ability to service the debt.

Furthermore, when you hear wild comments about how you can be assured of unlimited finance, you should ask yourself, "How does this alter my serviceability or security?" Unless an asset restructure (or similar strategy) increases your serviceability (increases income or reduces expenses) or security, then it's unlikely to increase your borrowing capacity.



Newspapers are full of dire warnings from the Reserve Bank and other financial commentators warning of the dangers of over-borrowing. Smart investors will be heeding these warnings. In the endless quest for ever higher levels of debt, investors may wish to take some time to consider exactly what their financial circumstances will be when the inevitable rise in interest rates occurs.

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