Risky features

Nothing ventured, nothing gained… but when is the risk too great? We take a closer look at seven potential risk factors when investing in units, to uncover the truth behind the claims

As you travel the well-trodden path to property investment, you're bound to come across conflicting schools of thought. There are almost as many different theories as there are apartment blocks, and it can be difficult to wade through the natter to find the truth.

What some consider dicey, others see as shrewd; the key is to be aware of the dangers and minimise the risk. We consult the experts on the top seven risky features of unit investment.

1 Ageing apartments

Some say that an apartment, like a fine wine, only gets better with age. The opposing argument is that older apartments are fraught with danger when it comes to investing. And still others, like Chris Gray, CEO of Empire property consultancy, say it's all simply a matter of opinion.

"There's no right or wrong," Gray explains. "It all depends on that particular property and price. I typically buy 95% second-hand properties and 5% new." Similarly, Martin Schoeddert, director of Iris Property, says there's no black and white answer. "The bottom line is that there's absolutely no perfect solution to anything."

The advantages of opting for a new property are many: investors can expect fewer ongoing maintenance issues, a contemporary and attractive street appeal and potentially greater tenant demand.

The biggest lure of a new apartment, however, is the tax depreciation on offer. Investors can write depreciation off as a tax-deductible expense and subsequently increase their cash flow – and the rewards get progressively better the newer a property is. Depreciation rates depend on a property's age, with apartments less than 10 years old collecting the greatest benefits.

Tyron Hyde, director of quantity surveying firm Washington Brown, says there are two types of allowances available: depreciation on plant and equipment, and depreciation on building allowance.

'Plant and equipment' refers to items within the building, such as carpets, blinds and ovens, while 'building allowance' refers to construction costs of the building itself, such as concrete and brickwork.

"Both these costs can be offset against your assessable income," explains Hyde.

While plant and equipment isn't subject to a commencement date, building allowance is. "In order to claim the building allowance on residential properties, construction must have commenced after 18 July 1985," says Hyde. "If construction commenced between 18 July 1985 and 16 September 1987, you can claim 4% pa of the building cost. If construction began after September 1987, the rate drops to 2.5% pa."

In the table below, Hyde uses the Washington Brown Depreciation Calculator (found on www.washingtonbrown.com.au) to compare the depreciation benefits of a brand new high-rise apartment with a 10-year-old apartment, and then one built in 1980. "Brand new property will yield the highest depreciation," explains Hyde. "This makes sense as the depreciation available on the construction cost is at its entirety, ie, 40 years. A 10-year-old high-rise apartment still has significant depreciation left available to the investor, while residential property built before July 1985 differs significantly in terms of depreciation. This is because you can't claim the building allowance or structure of the building against your taxable income."

However, Gray warns that while depreciation tax benefits are beneficial for cash flow, investors should always focus on assessing the potential of the underlying investment. "Calculate what the investment is worth now and by how much it's likely to grow in the future," he says. "There is little opportunity to add value to brand new apartments as they've been designed to be on-sold at a premium. Developers that sell brand new apartments are professional vendors and so often the property is very highly priced."

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For this reason, older apartments may be the way to go for entry-level investors after an affordable price tag. "Older-style properties are typically sold by mum and dad owners," explains Gray. "Not being professional sellers, they don't go to the extremes of de-cluttering and styling the property ready for sale, so second-hand properties typically sell for a more realistic price. Buyers can then add value through their own renovations."

Depreciation comparison: new vs old apartments

Year	Brand new $500,000 high-rise apartment	10-yr-old $500,000 high-rise apartment	Built in 1980 $500,000 high-rise apartment
Year 1	$13,000	$11,000	$5,000
Year 2	$11,000	$8,000	$2,000
Year 3	$10,000	$7,000	$2,000
Year 4	$9,000	$6,000	$1,000
Year 5	$8,000	$6,000	$1,000
Year 6	$8,000	$6,000	$1,000
Year 7	$8,000	$5,000	n.a
Year 8	$7,000	$5,000	n.a
Year 9	$7,000	$5,000	n.a
Year 10	$7,000	$5,000	n.a
Total	$260,000	$180,000	$12,000

Source: Tyron Hyde, Washington Brown Depreciation

Investors should also be wary of exceptionally high strata levies in newer apartment blocks. As contemporary buildings offer more and more facilities – such as concierge and valet services, gyms and swimming pools – the associated levies are rising to new heights, which can seriously harm your cash flow.

Schoeddert suggests that older apartments may be the way to go for investment. "My preference is for older apartments for a couple of reasons. The key reason is that if you're the sort of person who's happy to renovate and value-add, you'll enjoy better capital growth than just the depreciation allowances."

However, Schoeddert's advice does come with a word of warning. "You have to be really careful with a lot of the [unit blocks] that were built in the late 1960s and early 1970s as a very, very high percentage of them have got concrete cancer," he warns. "Make sure you get a really good look at the building inspection, get a good look at the Section 70 certificate, and make sure – and this is crucial to any unit investment – to have a really, really good look at how much is in the administration and sinking fund, so that you're not getting hit with

Case study

Turning risks into rewards

The property	
Purchase price (2003)	$232,000
Sale price (2005)	$295,000
Profit	$63,000
Furnishing cost	$4,000
Rent amount	$490/week

It was nothing but a plan on the page, but now, seven years later, Julian Ackad's off-the-plan investment is a profitable one-bedroom apartment in the heart of the Brisbane CBD.

This was a wise choice for the then-19-year-old, who was approached by a sales agent in 2003 with an offer he couldn't refuse. "There were only around six apartments [in the block] remaining, which were being sold at a discount to enable the developer to finalise finance arrangements and proceed with construction. The contract price was $232,000, discounted from the first release price of $245,000," Julian explains.

"I did my research and concluded that the apartment was good value based on then-current market values and there was a good chance that by the time the building was completed, some 18 months later, the contract price would be below market value."

After completing his first property purchase the year before, Julian had been told by the banks that he couldn't borrow again until his loan serviceability improved. "I saw this as a challenge rather than an obstacle," he muses. "I'd just developed a taste for property and was determined to build a portfolio regardless of what the banks said."

Julian used a $300 deposit bond to secure the property and entered into an off-the-plan contract knowing that in 18 months' time he could either finalise the purchase himself or on-sell. But 18 months stretched into two-and-a-half years, and as the timeframe changed, so too did ulian's circumstances.

"In 2004, I started a full-time degree studying property and, as a result of going from a full-time to a part-time income, I wasn't able to arrange finance to purchase the apartment myself. My parents agreed to take on the contract and purchase the apartment in their name on completion," says Julian.

That day finally arrived in 2005, when the market value of the apartment sat at approximately $295,000 – a healthy on-paper profit of $63,000. Julian was able to pass the contract on to his parents with no trouble, thanks to the addition of 'and/or nominee' after his name on the contract.

Julian recommends that all off-the-plan buyers do this to ensure they have the opportunity to on-sell the property on completion. "If you forget this you may be forced to complete the contract, pay stamp duty and other purchase-related costs, then on-sell with much less profit."

The 61m^2 apartment, including an 8m^2 balcony, sits on the 11th level of a 38-storey block in Mary Street, Brisbane. Just a stone's throw from the Queen Street Mall, Brisbane River, City Botanic Gardens and Queensland University of Technology, and with on-site facilities such as a gym, spa, sauna and heated lap pool, the Ackads' investment is an executive tenant's dream.

With Julian's parents at the helm, the apartment was furnished at a cost of $4,000 and is now being leased at an investor-friendly $490 per week.

"My parents are extremely happy with the apartment and it's providing positive cash flow for them," Julian explains.

Although his investment carried two potentially risky features – being a one-bedroom property and purchased off-the-plan – the young investor says it was undoubtedly successful. Construction delays weren't even a concern, as the purchase price was locked in and market values were rising.

"Buying off-the-plan is an inherently risky investment," Julian says. "Markets change and it's possible that you could have to complete a contract with a purchase price that's above market value. It's important to make sure that you're comfortable with the risk involved in buying off-the-plan. If your risk profile is such that you'll be anxious about the values dropping and losing money, then perhaps off-the-plan isn't for you."

Julian suggests that investors consider a few key factors before embarking on an off-the-plan purchase. "It may sound obvious, however, it's important to make sure the contract price isn't above current market value. Do your research by viewing recent comparable sales and speaking to several agents about similar properties."

He adds that property buyers should also consider the future balance of supply and demand to ensure that similar properties won't be in oversupply by the time the product hits the market.

"In a rising market, buying off-the-plan can be a very lucrative strategy; however, it's not without some form of risk," he adds.

special levies." If you do get nailed with a special levy, you could be up for thousands, which means your rental income will be headed straight to the levy, completely bypassing your wallet.

Investors also need to consider the state of the market when deciding if an old or new apartment is the way to go. CEO of Residex, John Edwards, advises that older units may be a wise choice in the current cycle, especially those that are located in Sydney. "Sydney units which are well-positioned (close to transport hubs) and are more than a decade old look as if they're going to see the best growth. Having said this, avoid suburbs where there are significant volumes of new developments taking place," he said in April's *Market Wrap*.

He adds that the entry of new units into the market will effectively drive down prices for their older counterparts in the same area, giving investors a greater opportunity to negotiate prices. Lower buying costs should also translate to higher yields.

2 Small apartments

Some experts warn against investors buying into studios or one-bedroom apartments, suggesting that a smaller dwelling may have less potential to add value and subsequently have limited capital growth.

They say the buyer market is also limited, which places significant pressure on the apartment to achieve strong rental returns. These rental returns are a cause for concern, says Gray, who believes that inflated per-person rental payments in smaller dwellings might be too high to attract a sufficient pool of tenants.

"While one-bedroom and studio apartments cost less money to buy, they can be typically more expensive per person to rent and that can limit the number of people who want to rent or buy them," he explains.

The data in the table below compares average rental amounts paid per person for studio, one, two and three-bedroom apartments. "The table shows that it's very expensive for one person to rent a studio or one-bedroom apartment, whereas it's much cheaper for two people to rent a more expensive two-bedder as they can split the weekly rent two ways. Three-bedders are cheaper to rent again, however, fewer people want to share between three," explains Gray.

"While your decision will ultimately depend on the suburb and its demographic, a two-bedroom apartment is usually a good choice."

You should consider the demographics of the tenant market in the area before deciding whether a smaller or larger apartment is the way to go. Students based around university nodes and short-term workers in major city areas are more likely to opt for studio and one-bedroom apartments than tenants wanting to live in the family-dominated suburbs.

Michelle Galletti, managing director of Just Rent Sydney, suggests that a smaller, furnished apartment in inner-city and city fringe areas will always experience strong demand. "It's almost like a hotel kind of scenario, but it's more long term," she says. "It's cheaper, obviously, for people from overseas to rent a fully-furnished apartment for a short period of time than it is for them to pay for hotel accommodation. So a lot of companies go for fully-furnished apartments in the city."

Schoeddert agrees that serviced studio and one-bedroom apartments located close to city centres and/or conference facilities are in hot demand. "In many instances, the return on a serviced apartment is better than a normal tenancy."

Recent data from the Australian Bureau of Statistics may reduce the perceived risk of investing in small apartments, as it points to an increasing trend of people living alone. The

Approximate rent for units

Property type	Purchase price	Weekly rent – I person	Weekly rent – 2 people	Weekly rent – 3 people
Studio	$300,000	$300/person	n.a	n.a
1-bed	$400,000	$400/person	n.a	n.a
2-bed	$500,000	n.a	$250/ person	n.a
3-bed	$600,000	n.a	n.a	$200/person

Source: Chris Gray, Empire

Unit check list

FEATURES TO LOOK FOR

- ☐ Affordable purchase price
- ☐ Good location
- ☐ Close to public transport
- ☐ High rental yield
- ☐ Strong tenant demand
- ☐ Attractive street appeal
- ☐ Sufficient parking, preferably internal garage space
- ☐ Natural light
- ☐ North-facing aspect
- ☐ Capital growth potential

FACTORS TO CONSIDER

- ☐ Depreciation benefits
- ☐ Opportunity to add value
- ☐ Suitability for existing tenant market
- ☐ Number of bedrooms
- ☐ Location within building
- ☐ Strata levy costs
- ☐ Administration and sinking fund balances

ABS report 'Household and Family Projections, Australia, 2001 to 2026' reveals that lone-person households are expected to show the greatest increase of all household types over this quarter of a century. The number of people living alone in Australia is expected to increase by between 57% and 105%, from 1.8 million households in 2001 to between 2.8 million–3.7 million households in 2026.

Schoeddert sees no problem in investing in studio and one-bedroom apartments. "I guess in a dream world, if affordability wasn't an issue, then a two or three-bedroom place with a double garage would be great. But for entry level stuff, I wouldn't hesitate to get into a one-bedroom or a studio."

3 High-rise blocks

When an asset's value relies on its scarcity factor, the idea of a sky-scratching high-rise seems to scream 'risk' from all angles. Indeed, many experts suggest steering clear of huge cookie-cutter unit blocks and instead opting for smaller blocks with a smaller number of investors.

High-rise apartment blocks can limit opportunities for investors, as increased competition restricts resale potential and rental demand. Your investment won't be unique if there are a few hundred identical products in the exact same block, all competing for the same tenants and/or buyers.

Look for blocks with fewer units and a higher proportion of owner-occupiers – experts suggest at least a 70:30 ratio of owner-occupiers to investors.

Schoeddert agrees that bulky blocks can be hazardous, particularly when it comes to weighing in on block decisions. "To me, from the investment point of view, as a single unit-holder in a big apartment block you can't exercise anything, you haven't got enough grunt in the owners corporation to have any effect at all. You can get out-voted in no time flat; they could say 'we want to redecorate the lobby' and if it's in a block of 80, you've got no choice."

Schoeddert suggests investors opt for blocks that are "small and containable", ideally housing around six to eight units over two or three floors.

4 Oversupplied unit market

As for any property investment, an oversupplied market is one that should be avoided. Apartments, in particular, tend to reach saturation point in certain locations periodically. Consider the relationship between supply and demand in the local market and predict which route it will take in the future. If you see masses of unit developments sprouting from the ground and under construction, it might be a signal to stay away from that area.

Hotspotting.com.au founder Terry Ryder points to the prestige unit markets in Darwin, the Gold Coast and the Sunshine Coast as ones that are in oversupply right now.

Look for locations where the supply of units on the rental market isn't meeting demand and you'll be well-aligned to rake in the profits. Talk to sales agents on the ground and assess ABS demographic data. Suburbs like Ultimo and Haymarket in Sydney, for example, are ones which are dominated by a high number of unit blocks, yet apartments are still in demand. The high percentage of lone-person households and student residents in the area continue to sap supply.

Gray points to both Sydney and Melbourne as markets that are ripe for unit investment. "The housing squeeze in Sydney and Melbourne means that units are never oversupplied in suburbs located 5–15km from the CBD," he says. "CBDs can become oversupplied from time to time as these may be the only place that developers can keep building upwards. This means there's really no limit to the supply, but demand is finite."

5 Premium price

Prestige apartments are inherently risky investments. Value-adding opportunities are dampened, the chances of overcapitalising are high and the top end is often the first to go when the going gets tough.

An astronomical buy-in price means that rental amounts need to fly to achieve even a moderate rental yield, and positive cash flow is a distant dream for investors. For example, the prestige Sydney suburbs of Cremorne Point, Dover Heights and Point Piper, which boasted median unit prices of $950,000, $905,000 and $1,775,000 respectively in May, achieved disappointing gross rental yields of only 3%, according to RP Data.

The higher strata levies associated with prestige properties can also cut significantly into any gains. "By definition, prestige apartments are only affordable for the top 10–20% of

the population rather than the 80% majority," says Gray. "As prices get higher, demand gets lower, and the rental return starts dropping to as low as 1–2%, which makes it hard to get cash flow if you have a large mortgage.

"Some investors choose to furnish their top-end investment apartment and rent it out as an executive rental; this can increase cash flow but can be very volatile as it is largely dependent on the economy."

Increased insurance premiums can also be of concern. General manager – insurance services of Terri Scheer Insurance, Carolyn Majda, says the cost of the company's Landlord Preferred Policy may increase for owners of top-end apartments renting at more than $1,000 a week. "If an apartment was rented for more than $1,000 per week and another apartment in the same building was rented for less than $1,000 per week, then their Landlord Preferred Policy insurance premiums would differ," she says.

"Landlords who own rental apartments can access the Terri Scheer Landlord Preferred Policy. This provides cover for malicious damage by tenants, accidental damage, deliberate damage, legal liability for occurrences on the property that cause death or bodily injury, and loss of rental income as a result of damage to a property or a tenant absconding."

Schoeddert suggests that investors should diversify their investments rather than pooling all their funds into one $2m–$4m apartment. "Personally, I think it's too risky; I think there are better ways of property investing," he says. The property expert instead suggests buying an entire block of units, or a company title block which you can then convert to strata title and on-sell, or really spread the risk by investing right across commercial, industrial and residential. "I wouldn't drop $3m or $4m on one single apartment, not from an investment point of view. It's way too risky."

6 Off-the-plan purchase

Purchasing property off-the-plan always carries an element of risk, but this is also an area of investment where you stand to make significant gains. As Schoeddert says, it's high-risk but worthwhile. It all comes down to the individual property and the direction of the market.

Gray says there are clear pros and cons when it comes to off-the-plan investment. It can be a great way to get into the property market with little outlay, as buyers can use deposit bonds and bank guarantees to stake their claim. However, should you fail to settle, you stand to lose a fortune. "If the market moves against you, you could be putting down a 20% deposit on the current cost, plus the amount the unit has dropped," explains Gray.

He suggests engaging the services of an independent valuer to gain a valid, impartial assessment of the property's current value, as well as sourcing reputable research to predict which way the market will go. You should ensure you have sufficient equity and a plan in case the market blows the wrong way.

But if your stars align and the investment is a wise one, you could make significant gains by the time the project reaches settlement. "If the market is growing rapidly, you buy at today's price but then settle in a few years' time when the price has ideally grown at 10–20%," says Gray. "If it all works out, and that 80% the bank lends you on settlement is more than the purchase price, you could end up with an apartment with no deposit down."

7 Position in apartment block

Is any one level of an apartment block a riskier investment option than another? Is top floor better than ground floor – or is a middle-level apartment a safer bet?

Those in favour of ground-floor units argue that their position places no constraint on the tenant market, whereas top-floor apartments may cut out certain groups such as those with prams, wheelchairs and the elderly.

Those who barrack for the top floor, however, say that they offer a more open feel as there is less chance of being built in and overshadowed by surrounding buildings. Top-floor tenants will also enjoy more privacy as their balconies are less likely to stare straight into another building. Apartment blocks with views will obviously favour the higher floors, which can be a huge boost to the property's value.

Security, noise and insulation all weigh in on the debate, with experts expressing concerns about easier access to ground-floor units and potential noise issues for units on the lower levels. Depending on the building, top-level apartments may also benefit from a better aspect and more natural light.

Purchase price may also enter the equation when assessing which level is a better option for you. The higher a unit is located in a block, the more expensive it may be. For example, apartments in the recently completed Whitsunday Reflections development in Airlie Beach, Queensland, increase in value the further up in the building they are located. According to Dave Alcock, project marketing consultant with PRDnationwide Whitsunday, two-bedroom apartments cost $550,000 for the ground floor, $563,000 for the middle floor and $583,000 for the top floor in a three-level block.

Schoeddert says that one cannot quantifiably say that one level is a better investment than any other. Decide who your likely tenant market is and make your investment choice accordingly. The right choice, ultimately, will be up to you.